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## Justification Norms Under Uncertainty: A Preliminary Inquiry

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### Recommended Citation

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# **CONNECTICUT INSURANCE LAW JOURNAL**

Volume 17, Number 1  
Fall 2010



University of Connecticut School of Law  
Hartford, Connecticut

*Connecticut Insurance Law Journal* (ISSN 1081-9436) is published at least twice a year by the Connecticut Insurance Law Journal Association at the University of Connecticut School of Law. Periodicals postage paid at Hartford, Connecticut. Known office of publication: 55 Elizabeth Street, Hartford, Connecticut 06105-2209. **Printing location: Western Newspaper Publishing Company, 537 East Ohio Street, Indianapolis, Indiana 46204.**

Please visit our website at <http://www.insurancejournal.org> or see the final page of this issue for subscription and back issue ordering information.

Postmaster: Send address changes to Connecticut Insurance Law Journal, 55 Elizabeth Street, Hartford, Connecticut 06105-2209.

The Journal welcomes the submission of articles and book reviews. Both text and notes should be double or triple-spaced. Submissions in electronic form are encouraged, and should be in Microsoft™ Word™ version 97 format or higher. Citations should conform to the most recent edition of A UNIFORM SYSTEM OF CITATION, published by the Harvard Law Review Association.

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**VOLUME 17****2010-2011****NUMBER 1**

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# CONNECTICUT INSURANCE LAW JOURNAL

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## REGULATING RISK BY “STRENGTHENING CORPORATE GOVERNANCE”

*Paul Rose\**

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*This essay, prepared for the “Regulating Risk” symposium of the Connecticut Insurance Law Journal, reviews the connection between risk and corporate governance, then examines the “Strengthening Corporate Governance” provisions of Subtitle G of the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank). The corporate governance provisions, covering proxy access and the separation of the roles of CEO and chairman of the board, seem likely to have one of two possible effects. On the one hand, the provisions may be pernicious, in that they further enhance shareholder power without a clear justification for increased shareholder power, and more particularly without a justification for shareholder power as a risk management device. Indeed, Dodd-Frank’s corporate governance provisions may work at cross-purposes to the risk management intent of the remainder of Dodd-Frank: the corporate governance provisions operate under the assumption that enhanced shareholder power will result in better monitoring of managerial behavior, which presumably will help to prevent future crisis, but both theory and evidence suggest that diversified shareholders generally prefer companies to take risks that other constituencies (including taxpayers) would not prefer.*

*On the other hand, Dodd-Frank may have very little effect on investor behavior or risk management. Increases in shareholder power over the past years (fundamentally the result of increased federal regulation) have made management more responsive to - and in some cases probably overly responsive to - shareholder concerns over agency costs. Indeed, some of the proposed reforms already have been or were likely to have been put in place at most public companies. If private ordering is already working, what is the point of imposing strict governance constructs across the*

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\* Assistant Professor of Law, Ohio State University – Moritz College of Law. This essay benefited from comments at the Conference on “Regulating Risk” at the University of Connecticut School of Law, April 16, 2010. Any errors are attributable solely to the author.



*market as a whole, especially when most of the affected firms are victims of, rather than contributors to, the Financial Crisis'*

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## I. INTRODUCTION

Of the many explanations of the Financial Crisis of 2008, perhaps the most pervasive is the linkage of the crisis to managerial greed: the crisis as the result of managerial expropriation and excessive risk-taking permitted by lax corporate governance and risk management. To assess the characterization of the Financial Crisis as a governance crisis, we must test the strength of the links between managerial behavior, corporate governance and risk management. Certainly, in the run-up to the Financial Crisis existing systems of governance and risk management failed to detect and mitigate firm-level risks before they became systemic risks. Are these failures of risk management ultimately corporate governance failures? If they are, how do we address them?

Regulators and firms can (and do) attack governance problems from multiple angles. Firms incentivize managers better by constructing executive compensation schemes that closely link operating and/or stock performance to compensation. Firms create monitoring systems that allow managers and directors to recognize, evaluate, and mitigate risks to the enterprise, and regulators create monitoring systems within regulatory structures that allow them to recognize, evaluate, and mitigate systemic risks created by a myriad of firm decisions. Regulators provide regulatory support for a vigorous market for corporate control and impose, either through new regulations or through existing corporate governance mechanisms (such as proxy voting), governance structures that limit managerial authority and/or increase managers' accountability to shareholders.

This essay will focus on a specific effort of this last means of managing agency costs—regulated governance arrangements—as a means of managing both systemic and firm-specific risk. The essay will first briefly consider the connection between risk management and corporate governance, showing how the two are often linked. This link is implicitly assumed by the recently passed Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). The second part of this essay will consider the Dodd-Frank Act's assumptions concerning risk management and shareholder power, and will argue that in the worst case the Dodd-Frank Act exacerbates rather than mitigates risk, and in the best case is merely a pointless exercise in political crisis management that will

have no significant positive or negative effect on corporate governance or risk management.

## II. LINKING RISK MANAGEMENT AND CORPORATE GOVERNANCE

Risk management, broadly conceived, is an essential aspect of good corporate governance, and vice versa. However we define corporate governance (as a description of the relationship between corporate stakeholders, as a set of rules or processes governing the corporate entity, etc.), risk management works hand in hand with corporate governance as a means of constraining agency costs and promoting efficient and prudent management. Indeed, risk management so overlaps with corporate governance that the terms may sometimes be used synonymously. Because risk management practices in many financial firms failed during the Financial Crisis, it has been said that corporate governance failed during the Financial Crisis<sup>1</sup>—if this is true, the Financial Crisis is not a risk management problem but a larger crisis in corporate governance. In this essay I do not seek to dispute that corporate governance failures at some firms contributed to the Financial Crisis. However, even if we assume that this is the case, determining *which aspects* of corporate governance failed is crucial: as Brian Cheffins has noted, important normative implications flow from this determination.<sup>2</sup> If the failure is in part due to incentive compensation systems, should these systems be subject to additional regulation, and if so, how should they be regulated? If the failure is also due to failures of internal controls systems, should we rethink or enhance the regulatory framework under Section 404 of Sarbanes-Oxley?

At the level of each specific firm, the precise nature of the failure of governance and risk management is likely to be somewhat different. Perhaps like Tolstoy’s unhappy families,<sup>3</sup> each is unhappy in its own way and failed for reasons that elude a simple narrative of greed or hubris. As we continue to unravel the causes of the crisis, we do find some common factors in the stories of financial firms like Bear Stearns, Lehman Brothers,

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<sup>1</sup> See Brian R. Cheffins, *Did Corporate Governance “Fail” During the 2008 Stock Market Meltdown? The Case of the S&P 500*, 65 BUS. LAW. 1, 2 (2009).

<sup>2</sup> See *Id.* at 3.

<sup>3</sup> See LEO TOLSTOY, *ANNA KARENINA* 1 (Richard Pevear & Larissa Volokhonsky trans., Penguin Books Deluxe ed. 2002) (1877).

AIG, and others. William Sahlman has aptly summed several common factors:

In studying the financial crisis as it unfolded over the past couple of years, it seems clear that many organizations suffered from a lethal combination of powerful, sometimes misguided incentives; inadequate control and risk management systems; misleading accounting; and, low quality human capital in terms of integrity and/or competence, all wrapped in a culture that failed to provide a sensible guide for managerial behavior. This assessment refers to financial services firms like Countrywide, AIG and Bear Stearns; it also applies to other actors like regulatory agencies, politicians, ratings agencies and probably to individual consumers.<sup>4</sup>

One of the financial firms that suffered from this “lethal combination,” UBS, provided its shareholders with a frank assessment of its risk management and governance failures. The 50-page report<sup>5</sup> provides a helpful catalog of the numerous specific failures at UBS, the majority of which almost certainly affected most other financial firms, including:

- Incomplete risk control methodologies.<sup>6</sup>
- Insufficient challenge of the business case and governance approach.<sup>7</sup>
- Inappropriate risk metrics used in strategic planning and assessment.<sup>8</sup>
- Failure to own the business.<sup>9</sup>

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<sup>4</sup> William A. Sahlman, *Management and the Financial Crisis (We have met the enemy and he is us . . .)* 4 (Harv. Bus. Sch., Working Paper No. 10-033, 2009), available at <http://www.hbs.edu/research/pdf/10-033.pdf>.

<sup>5</sup> UBS AG, SHAREHOLDER REPORT ON UBS'S WRITE-DOWNS (Apr. 18, 2008), available at [http://www.ubs.com/1/ShowMedia/investors/share\\_information/shareholderreport?contentId=140333&name=080418ShareholderReport.pdf](http://www.ubs.com/1/ShowMedia/investors/share_information/shareholderreport?contentId=140333&name=080418ShareholderReport.pdf).

<sup>6</sup> *Id.* at 29.

<sup>7</sup> *Id.* at 33.

<sup>8</sup> *Id.* at 34.

<sup>9</sup> *Id.* at 36.

- Ex-post review versus pre-agreed limits [asking for forgiveness rather than permission].<sup>10</sup>
- Failure to respond to wider industry concerns.<sup>11</sup>
- Over-reliance on VaR.<sup>12</sup>
- Over-reliance on [debt] ratings.<sup>13</sup>
- Lack of recognition of idiosyncratic risk.<sup>14</sup>
- Asymmetric risk / reward compensation.<sup>15</sup>
- Insufficient incentives to protect the UBS franchise long-term.<sup>16</sup>

With UBS, we indeed recognize powerful, sometimes misguided incentives (in the form of trader and management compensation);<sup>17</sup> inadequate control and risk management systems that could not adequately evaluate and respond to risks; misleading accounting (UBS restated its financials for 2008);<sup>18</sup> and, low quality human capital in terms of integrity and/or competence (lack of a willingness to challenge the bankers at UBS, and a decline in the number of skilled risk managers).<sup>19</sup>

If UBS’s risk management and governance problems were typical, we might ask how better corporate governance at UBS could have prevented the crisis. Arguably, management (including the board) should

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<sup>10</sup> *Id.* at 37.

<sup>11</sup> UBS AG, *supra* note 5, at 37.

<sup>12</sup> *Id.* at 38. A 2009 article by Joe Nocera contains two pithy quotes from two famous VaR Skeptics:

David Einhorn, who founded Greenlight Capital, a prominent hedge fund, wrote not long ago that VaR was ‘relatively useless as a risk-management tool and potentially catastrophic when its use creates a false sense of security among senior managers and watchdogs. This is like an air bag that works all the time, except when you have a car accident.’ Nassim Nicholas Taleb, the best-selling author of ‘The Black Swan,’ has crusaded against VaR for more than a decade. He calls it, flatly, ‘a fraud.’

Joe Nocera, *Risk Management*, N.Y. TIMES MAG., Jan. 4, 2009, at 24, 26-27.

<sup>13</sup> UBS AG, *supra* note 5, at 39.

<sup>14</sup> *Id.*

<sup>15</sup> *Id.* at 42.

<sup>16</sup> *Id.*

<sup>17</sup> Sahlman, *supra* note 4, at 4.

<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

have recognized the dangers in the subprime market and begun to de-lever (debt to equity ratios were 30:1 at Lehman and Morgan Stanley).<sup>20</sup> With the benefit of hindsight, it seems that UBS's internal controls systems were not adequate, that risk managers were using incomplete information and incomplete models, and that UBS had a culture that was focused on short-term profits and, in the words of the report, had "[i]nsufficient incentives to protect the UBS franchise long-term."<sup>21</sup> But even with the risk management systems then in place, one may ask why risk managers could not anticipate the crisis. I suspect that many risk managers did, in fact, recognize the problems in the housing and credit markets before the crisis, but obviously did not anticipate the magnitude of the problem, nor appreciate the interconnectedness of financial institutions. Some probably did express their concerns to management, and perhaps their concerns were discounted.

A better question might be to ask why managers believed that they could time the market so that they would be able to stop dancing just as the music stopped playing, sure in the knowledge that risks would have been passed along to someone else or adequately hedged, and that we would make the fabled "soft landing" that Fed Chairman Ben Bernanke predicted in February 2007.<sup>22</sup> A partial answer to this question may be found in behavioral explanations of the Financial Crisis, but a simple explanation may also be found in the incentives of the managers. Citigroup, for example, had to "keep dancing," as Chuck Prince put it, in order to stay competitive with other banks. The low rates brought about by Fed policy helped drive the leveraged buyout business; banks like Citi had "no credibility to stop participating in this lending business . . . My belief then and my belief now is that one firm in this business cannot unilaterally withdraw from the business and maintain its ability to conduct business in the future."<sup>23</sup> He believed that "if you are not engaged in business, people leave the institution, so it is impossible to say in my view to your bankers we are just not going to participate in the business in the next year or so

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<sup>20</sup> Michael J. de la Merced, Vikas Bajaj & Andrew Ross Sorkin, *As Goldman and Morgan Shift, a Wall St. Era Ends*, N.Y. TIMES DEALBOOK (Sept. 21, 2008, 9:35 PM), <http://dealbook.blogs.nytimes.com/2008/09/21/goldman-morgan-to-become-bank-holding-companies/>.

<sup>21</sup> UBS AG, *supra* note 5, at 42.

<sup>22</sup> Edmund L. Andrews, *Fed Chief Says Outlook Is Positive*, N.Y. TIMES, Feb. 15, 2007, at C10.

<sup>23</sup> Cyrus Sanati, *Prince Finally Explains His Dancing Comment*, N.Y. TIMES DEALBOOK (Apr. 8, 2010, 2:04 PM), <http://dealbook.blogs.nytimes.com/2010/04/08/prince-finally-explains-his-dancing-comment/>.

until things become a little more rational. . . . You can’t do that and expect to have any people left to conduct business in the future.”<sup>24</sup>

How, then, should we characterize the governance failures at UBS and other financial firms, and how do they relate to risk management? Certainly the control systems—and particularly the risk management systems—failed, though perhaps not in every case due to a reckless indifference to risk. As with the failure of Long Term Capital Management over a decade ago, the state of the art in hedging and risk management simply was not good enough, and a failure to respond to warning signs and challenge existing models and business practices clearly contributed to the collapse. Moreover, I believe that the incentive structures were also flawed in that traders and originators had incentives to take on excessive risk without internalizing the costs of that risk. Where appropriate limits are placed on trading activities—a real back office check on the risk assumed by the front office—a high-reward incentive structure is less problematic. The problem comes when lax controls are combined with incentives to take heavy risk.

Over both of these areas—risk management systems and incentive schemes—management and the board must provide oversight. Generally, they are obligated to ensure that systems are created and function effectively in controlling (but not hobbling) the animal spirits that drive the business forward. With this understanding, the governance structures at most major financial institutions (excepting perhaps Goldman Sachs) can be said to have failed from a risk management perspective.

Although my description of how risk management failures can be described as failures of corporate governance may not offer the strongest argument in support of the position, I believe that it is at least a reasonable assessment of how the two failures may be linked. But importantly, even if we recognize that the Financial Crisis was a risk management crisis, and that as a risk management crisis it is in effect a corporate governance crisis, we have still only introduced a problem, and have not justified any solution to that problem. If we accept that poor corporate governance at least contributed to the Financial Crisis, we must now turn to the question of how corporate governance can be improved in order to better manage risk. This question was recently addressed in the sweeping Dodd-Frank legislation, in part through Subtitle G: “Strengthening Corporate Governance.” In the next section, I will focus on the assumptions

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<sup>24</sup> *Id.*

underlying Subtitle G's corporate governance prescriptions, and on the implications of the prescriptions for risk management.

### III. REGULATING CORPORATE GOVERNANCE TO MANAGE RISK

In this section, I will first begin by describing the governance provisions in the Dodd-Frank Act, then turn to an analysis of the assumptions underlying the governance provisions. I will then discuss the implications of the provision, focusing on how they are likely to affect risk management.

#### A. "STRENGTHENING CORPORATE GOVERNANCE": SUBTITLE G OF THE DODD-FRANK ACT

The first point of interest in the Dodd-Frank Act is its scope: Dodd-Frank's corporate governance provisions are not limited to "too big to fail" firms or financial services firms. They generally apply to any company traded on a national stock exchange. The Dodd-Frank Act does not explicitly preempt state law, but instead applies the SEC's power to approve listing standards of the national stock exchanges.<sup>25</sup> The Dodd-Frank Act contains provisions that affect shareholder rights and that focus on executive compensation.<sup>26</sup> Although appropriate incentive compensation is an important component of an overall corporate governance structure, other papers in this symposium provide a detailed analysis of the advisability of the compensation rules set out in the proposed regulations. This essay will focus on the corporate governance aspects of the Dodd-Frank Act that relate to shareholder rights.

The final version of Subtitle G of the Dodd-Frank Act contains two major corporate governance provisions:<sup>27</sup> 1) explicit approval of an SEC

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<sup>25</sup> Richard J. Sandler, *Corporate Governance and Executive Compensation in the New Dodd Bill*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Mar. 17, 2010, 8:34 AM), <http://blogs.law.harvard.edu/corpgov/2010/03/17/corporate-governance-and-executive-compensation-in-the-new-dodd-bill/>.

<sup>26</sup> *See id.*

<sup>27</sup> Other sections of the Dodd-Frank Act not discussed in this paper also cover important governance-related issues such as say-on-pay. This essay is limited to an analysis of Subtitle G.

proxy access rule;<sup>28</sup> 2) and a comply-or-explain provision on the separation of the CEO and board chairman position.<sup>29</sup> The Senate version of the bill contained a majority-voting requirement, but this was eliminated in a compromise with the House version of the bill.<sup>30</sup> A provision in the 2009 Dodd Bill, absent in all versions of the 2010 bill, would have prohibited classified boards unless approved or ratified by shareholders.<sup>31</sup>

### 1. Proxy Access

In a shift from the 2009 Dodd Bill,<sup>32</sup> the SEC “may” require proxy access for shareholders, rather than requiring the SEC to issue proxy access rules within 180 days of the Dodd-Frank Act’s enactment.<sup>33</sup> In response to this authority, on August 25<sup>th</sup>, 2010, the SEC approved rules that provided shareholders with the right to place director candidates on the corporate ballot. To be able to nominate a director under this rule, a shareholder or group of shareholders must hold 3% of the company’s shares for more than 3 years.<sup>34</sup>

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<sup>28</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. § 971 (2010) (enacted).

<sup>29</sup> *Id.* § 972.

<sup>30</sup> David S. Huntington, *Summary of Dodd-Frank Financial Regulation Legislation*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jul. 7, 2010, 9:15 AM), <http://blogs.law.harvard.edu/corpgov/2010/07/07/summary-of-dodd-frank-financial-regulation-legislation/>. In the Senate version of The Dodd-Frank Act, stock exchange listing requirements would have been required to include a majority vote standard in uncontested director elections for all listed companies. Plurality voting was permitted only in contested elections. A director receiving less than a majority of votes cast would have been required to submit his or her resignation. The board could have then refused the resignation, but the bill required that it then publicly explain why it did not accept the director’s resignation. The majority voting requirement would not have been met by the plurality-plus voting rules in place at many companies. Sandler, *supra* note 26.

<sup>31</sup> Sandler, *supra* note 25.

<sup>32</sup> *Id.*

<sup>33</sup> H.R. 4173, § 972.

<sup>34</sup> Lucian Bebchuck & Scott Hirst, *Proxy Access Is In*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Aug. 25, 2010, 11:20 AM), <http://blogs.law.harvard.edu/corpgov/2010/08/25/proxy-access-is-in/>.



## 2. CEO and Chairman Positions

The Dodd-Frank Act requires the SEC to promulgate rules mandating proxy statement disclosure concerning the separation of the CEO and chairman roles—companies must explain why the same or why different persons serve in these roles.<sup>35</sup> Similar disclosure is already required under the “Corporate Governance” disclosures mandated under Item 407 of Regulation S-K. In particular, Item 407(h) requires companies to “[b]riefly describe the leadership structure of the registrant’s board, such as whether the same person serves as both principal executive officer and chairman of the board, or whether two individuals serve in those positions....”<sup>36</sup> If one person serves as both CEO and chairman of the board, the company must “disclose whether the registrant has a lead independent director and what specific role the lead independent director plays in the leadership of the board.”<sup>37</sup> The disclosure should also explain “why the registrant has determined that its leadership structure is appropriate given the specific characteristics or circumstances of the registrant,”<sup>38</sup> and “disclose the extent of the board’s role in the risk oversight of the registrant, such as how the board administers its oversight function, and the effect that this has on the board’s leadership structure.”<sup>39</sup>

## B. ASSUMPTIONS OF THE DODD-FRANK ACT

The corporate governance provisions of the Dodd-Frank Act suggest several tenuous assumptions about the role of corporate governance in preventing financial crises. First, the inclusion of the provisions in the Bill arguably assumes that the governance structures required by the provisions could have helped prevent the Financial Crisis of 2008, or at least limited its effects on compliant firms. More specifically, the Dodd-Frank Act makes assumptions about the desirability of shareholder power and the risk preferences of shareholders. Each of these assumptions has tenuous support.

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<sup>35</sup> Huntington, *supra* note 30.

<sup>36</sup> 17 C.F.R. § 229.407(h) (2010).

<sup>37</sup> *Id.*

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

1. Could the Provisions have Helped Prevent the Financial Crisis?

There is plenty of blame to go around when one looks for causes of and contributions to the Financial Crisis. The question as posed—could the Dodd-Frank Act’s provisions have helped to prevent the Financial Crisis?—may be interpreted so broadly that it becomes unreasonable. I doubt that anyone would argue that the whole of the blame for the Financial Crisis rests on a few corporate governance practices that the Dodd-Frank Act intends to cure. But even if we think of the question more narrowly—that the “right” corporate governance practices could have provided more warning, could have added accountability to corporate governance, could have ensured more independent thinking by the board that may have resulted in decisions that would have at least helped mitigate some of the effects of the crisis—Dodd-Frank implicitly holds expectations of the value of corporate governance. More precisely, the Dodd-Frank Act assumes a need for mandatory, one-size-fits-all corporate governance reform and shareholder empowerment.

As a preliminary matter, the evidence that corporate governance matters for firm performance is uneven.<sup>40</sup> Intuitively, this is primarily due to the fact that “good” corporate governance is firm-specific and often based on qualities, such as corporate culture, that are not readily quantifiable and so are difficult or impossible to reduce to a set of metrics. Determining causation in governance and performance is challenging, and corporate governance research is replete with studies attempting to isolate a particular metric (say, the separation of the CEO and chairman roles) to determine whether the separation improves some measure of firm performance. Much effort has recently gone into determining the accuracy of the good governance metrics offered by governance ratings firms and proxy advisors like RiskMetrics’ ISS unit. We have some evidence that some of the metrics used by ratings firms can meaningfully predict

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<sup>40</sup> Bebchuk, Cohen and Wang reason that the failure to find an association between corporate governance and abnormal returns in the last decade is due to the fact that investors have learned to appreciate the differences between good-governance and poor-governance firms, and these differences have been factored into market prices. Lucian A. Bebchuk, Alma Cohen & Charles C. Y. Wang, Learning and the Disappearing Association Between Governance and Returns (unpublished discussion paper, no. 667), *available at* <http://ssrn.com/abstract=1589731>.

performance, but at least some of these studies were commissioned by or produced by the subject ratings firms.<sup>41</sup> Other independent work suggests that the ratings used by various firms do not accurately predict firm performance.<sup>42</sup> To underline an obvious but often disregarded point, proxy advisory and corporate governance ratings firms are, after all, businesses. They must have something of value to offer their clients, and they must differentiate their products by price or by methodology. It would be problematic for these firms if something basic—for example, share ownership by independent directors, as Professors Bhagat, Bolton and Romano’s work suggests<sup>43</sup>—is a more reliable predictor of firm performance than their multitude of metrics. A simple, single metric could be produced by the clients—institutional investors—relatively cheaply. Instead, we have a profusion of proprietary rating systems, each constantly tweaked and recalibrated—a process I call “methodology churn.” No two are alike, although the ratings are offered (at least by those firms that do not engage in detailed analysis of the companies they rate by particular governance issue) as though there were a single grand unified theory of corporate governance, perfectly expressed by their proprietary methodology. On this point, I note that Bebchuk, who is generally allied with the governance ratings firms in the general goal of promoting shareholder empowerment, has argued that governance ratings that try to impose a great number of “good governance” metrics on firms are less useful in predicting good governance than simply keying on a few

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<sup>41</sup> See, e.g., Lawrence D. Brown & Marcus L. Caylor, Corporate Governance and Firm Performance (Dec. 7, 2004), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=586423](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=586423) (creating a measure of corporate governance based on data from Institutional Shareholder Services).

<sup>42</sup> See e.g., Sanjai Bhagat, Brian Bolton & Roberta Romano, *The Promise and Peril of Corporate Governance Indices* (Eur. Corporate Governance Inst., Working Paper No. 89, 2007), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1019921](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1019921); Robert Daines, Ian D. Gow & David F. Larcker, *Rating the Ratings: How Good are Commercial Governance Ratings?* (Arthur and Toni Rembe Rock Ctr. For Corporate Governance, Working Paper No. 360, 2009), available at [http://law.stanford.edu/display/images/dynamic/publications\\_pdf/dg16-26-2008\\_1.pdf](http://law.stanford.edu/display/images/dynamic/publications_pdf/dg16-26-2008_1.pdf) (finding that there is no consistent relation between government indices and measures of corporate performance).

<sup>43</sup> Sanjai Bhagat, Brian Bolton & Roberta Romano, *The Promise and Peril of Corporate Governance Indices*.

problematic entrenchment devices such as poison pills<sup>44</sup>—in other words, it seems easier to spot “bad governance” structures than it is to effectively prescribe “good governance” structures.

The problems with the corporate governance industry metrics are instructive with respect to the particular provisions of the Dodd-Frank Act. As we inch closer towards a federally-mandated, one-size-fits-all corporate governance framework, companies, investors and regulators may begin to treat corporate governance and particular governance structures as an end rather than as means. Should we be surprised then, as ISS must have been, when a technically, superficially well-governed company like Enron turns out to be a whited sepulcher? Little faith should be placed in the risk management utility of mandatory “good governance” structures, and the Dodd-Frank Act provisions require practices and structures which, as will be discussed below, have uncertain governance value and potentially serious governance disadvantages.

## 2. Shareholder Power and the Risk Preferences of Shareholders

Cheffins has noted that “given the *zeitgeist*, it is doubtful whether any set of corporate governance arrangements could have forestalled the financial bandwagon on the loose in the mid-2000s. Amidst an implicit consensus among investors, politicians, regulators, journalists and even homebuyers that an overheating financial system was fundamentally sound, those preaching caution were marginalized.”<sup>45</sup> The irony of the Dodd-Frank Act is that things may have been worse if the Act were in place prior to the Financial Crisis. Indeed, it is when we analyze the Act’s assumptions about shareholder power and shareholder risk preferences that we recognize that investors were among those encouraging the banks to keep dancing.

Because shareholders, the residual claimants of the corporation, are diversified across markets and often across asset classes, they will often push management to swing for the fences. The Dodd-Frank Act assumes that shareholders are primarily interested in long-term value creation, but this assumption does not square with the behavior of many investors. Shareholders may have different risk preferences and attempt to influence

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<sup>44</sup> See Lucian Bebchuk, Alma Cohen & Allen Ferrell, *What Matters in Corporate Governance*, 22 REV. FIN. STUD. 783, 787 (2009).

<sup>45</sup> Cheffins, *supra* note 1, at 38.

managers to make decisions in line with those preferences. As outlined by the Aspen Institute's statement on "Overcoming Short-Termism,"<sup>46</sup> signed by John Bogle, Warren Buffett and others, the influence of money managers, mutual funds and hedge funds "who focus on short-term stock price performance, and/or favor high-leverage and high-risk corporate strategies designed to produce high short-term returns"<sup>47</sup> present several problems. First, many such investors' preferences work not only against other long-term-focused shareholders but against their ultimate investors' interests because high rates of portfolio turnover through frequent trading can significantly erode gains.<sup>48</sup> Second, fund managers focused on short-term trading gains "have little reason to care about long-term corporate performance or externalities, and so are unlikely to exercise a positive role in promoting corporate policies, including appropriate proxy voting and corporate governance policies, that are beneficial and sustainable in the long-term."<sup>49</sup> Also, managers and board members may harm the interests of shareholders seeking long-term growth and sustainable earnings by pursuing strategies designed to satisfy short-term investors; "This, in turn, may put a corporation's future at risk."<sup>50</sup>

Deeper shareholder involvement in corporate governance, as encouraged by the Dodd-Frank Act's corporate governance provisions, is designed to encourage more vigilant monitoring of managers and more prudent risk management. However, the UK experience suggests that this is unlikely to be the case. As Cheffins notes:

U.K. company law is, in various respects, more "shareholder-friendly" than the equivalent regime in the U.S., as U.K. shareholders have greater scope to call shareholder meetings, initiate changes to the corporate constitution and dismiss directors. . . . Regardless, it does not appear that banks were better managed in the U.K. than in the U.S. Moreover, bank shareholders apparently made

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<sup>46</sup> THE ASPEN INST., OVERCOMING SHORT-TERMISM: A CALL FOR A MORE RESPONSIBLE APPROACH TO INVESTMENT AND BUSINESS MANAGEMENT 2 (2009), available at <http://www.aspeninstitute.org/sites/default/files/content/images/Overcoming%20Short-termism%20AspenCVSG%2015dec09.pdf>.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

little use of the powers available to them. The chief executive of the U.K.’s financial markets regulator admonished major shareholders for being “too reliant and unchallenging” in the run up to Financial Crisis. Lord Myners, Financial Services Secretary in the U.K. Treasury, similarly chastised institutional shareholders as being “absentee landlords”. The experience in Britain implies that even if shareholder rights are increased in the U.S. in the aftermath of the stock meltdown of 2008, there is no guarantee shareholders will use the powers made available to them to forestall a similar future assault on shareholder value.<sup>51</sup>

David Walker, commissioned by the Prime Minister to review UK banks’ corporate governance in the wake of the Financial Crisis, makes a similar observation, and suggests that in some cases shareholder were complicit in excessive risk-taking:

Before the current crisis broke there appears to have been a widespread acquiescence by institutional investors and the market in the gearing up of banks’ balance sheets as a means of boosting returns on equity. This was not necessarily irrational from the standpoint of the immediate interests of shareholders who, in the leveraged limited liability business of a bank, receive all of the potential upside whereas their downside is limited to their equity stake, however much the bank loses overall in a catastrophe. The atmosphere of at least acquiescence in high leverage on the part of shareholders will have exacerbated critical problems encountered in some instances. And, while institutional investors could not have prevented the crisis, even major fund managers appear to have been slow to act where issues of concern were identified in banks in which they were investors, and of limited effectiveness in seeking to address them either individually or collaboratively. The limited institutional efforts at engagement with several UK banks appear to have had little impact in restraining management before the

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<sup>51</sup> Cheffins, *supra* note 1, at 45-46.

recent crisis phase, and it is noteworthy that levels of voting against bank resolutions rarely exceeded 10 per cent.<sup>52</sup>

Viewed in this light, shareholder power may not only fail to remedy risk management problems but also exacerbate them. If we view the Financial Crisis as a governance problem, it is not clear that the crisis is attributable to expropriation of principals' interests by management shareholders. Nestor Advisors, a corporate governance consultancy, argues that management does not seem to have short-changed shareholders in the Financial Crisis. Executives' financial interests were aligned with shareholders' interests. But in the case of banks, especially, this can be problematic: "Regulators, like everyone else, seem to have forgotten that, when it comes to firms that are by definition highly geared due to their maturity transformation function, full alignment with shareholder interest might be the riskiest of all alignments."<sup>53</sup>

At least from the point of view of banks, the shareholder empowerment envisioned by the corporate governance section of the Dodd-Frank Act thus may work at cross-purposes to the risk management purposes of the remainder of the Dodd-Frank Act. But even with non-financial companies, there is little evidence to support the notion that enhanced shareholder power as encouraged by the Dodd-Frank Act will improve the risk management function of corporate governance. Indeed, to the extent that influential shareholders encourage risk-taking by managers, the long-term interests of the corporation may suffer.

As a final note, consider the performance of Goldman Sachs in the Financial Crisis.<sup>54</sup> Because of a strong firm culture, Goldman's management was arguably the best-insulated from influential shareholder pressure; arguably, their relative success in navigating the crisis lies in the fact that Goldman treated risk management as though it were still a

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<sup>52</sup> DAVID WALKER, A REVIEW OF CORPORATE GOVERNANCE IN UK BANKS AND OTHER FINANCIAL INDUSTRY ENTITIES § 5.9 (2009), *available at* [http://www.hm-treasury.gov.uk/d/walker\\_review\\_consultation\\_160709.pdf](http://www.hm-treasury.gov.uk/d/walker_review_consultation_160709.pdf); *see generally id.* § 5 (discussing engagement, stewardship, collective action and governance).

<sup>53</sup> NESTOR ADVISORS, GOVERNANCE IN CRISIS: A COMPARATIVE CASE STUDY OF SIX US INVESTMENT BANKS 17 (2009), *available at* [http://www.nestoradvisors.co.uk/fileadmin/user\\_upload/articles/USBank09.pdf](http://www.nestoradvisors.co.uk/fileadmin/user_upload/articles/USBank09.pdf).

<sup>54</sup> For a discussion of Goldman in the Financial Crisis, see Nocera, *supra* note 12; Sahlman, *supra* note 4.

partnership—with partners internalizing losses as well as gains—rather than a corporation influenced by the short-term interests of certain investors.

### 3. The Act’s Provisions: Pernicious or Merely Pointless?

Given the potential higher appetite for risk associated with increased shareholder power, the Dodd-Frank Act’s corporate governance provisions seem to provide little enhancement to risk management. The corporate governance provisions are better understood as not directed towards the causes of the Financial Crisis, but rather as simply not letting a crisis go to waste<sup>55</sup>—packaging corporate governance reforms that have been long-sought by powerful Democratic constituencies with a bill that should be directed solely towards systemic risk management. More to the point, the corporate governance provisions would not be good legislation even if they stood alone, unconnected to the questions of risk management raised by the Financial Crisis. In the aggregate, the Dodd-Frank Act’s corporate governance provisions are likely to have pernicious<sup>56</sup> effects. Hopefully they will be merely pointless.

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<sup>55</sup> See Jeff Zeleny & Jackie Calmes, *Obama, Assembling Team, Turns to the Economy*, N. Y. TIMES, Nov. 7, 2008 at A1.

<sup>56</sup> In my symposium remarks, I noted the possibility that the Dodd-Frank Act could have pernicious effects on corporate governance, but I was not the only one to characterize the provisions in this way. See also Steven M. Bainbridge, *The Fruits of Shareholder Activism*, PROFESSORBAINBRIDGE.COM (June 3, 2010, 11:25 AM), <http://www.professorbainbridge.com/professorbainbridgecom/wall-street-reform/> (Steven Bainbridge provides an excellent analysis of the pernicious corporate governance provisions of Dodd-Frank).



*a) The Potentially Pernicious Effects of the Dodd-Frank Act*<sup>57</sup>

Proxy access has generated the most controversy of the two adopted provisions, having been the subject of several proposed SEC rules that generated thousands of comments. Like majority voting, proxy access is touted by its proponents as a step towards more democratic governance of the public corporation (notwithstanding the questionable value of democracy as applied to the corporate form<sup>58</sup>). However, empirical work on proxy access suggests that it is more likely to harm than help corporate governance. Grundfest, reviewing recent studies on stock price response to the SEC's earlier proxy access proposals, states that:

The best currently available empirical data thus indicate that, given a choice between the current regime and the Commission's proposed proxy access rules, shareholders seeking to maximize returns would prefer the status quo because the proposed rules appear to destroy shareholder wealth. Moreover, if there is to be a proxy access rule, the cross-sectional variation in the data suggest that an opt-in regime, in which shareholders define for themselves the rules governing proxy access on a corporation-by-

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<sup>57</sup> As indicated above, the majority voting standard was eliminated from the final version of the Act. This is just as well, because majority voting has been enacted at many public companies already, largely as a result of consistent pressure from institutional investors and the corporate governance industry in the past decade. See William K. Sjostrom & Young Sang Kim, *Majority Voting for the Election of Directors*, 40 CONN. L. REV. 459, 462 (2007). A recent study of the governance practices of the largest U.S. companies, conducted by Shearman and Sterling LLP, showed that 82 out of the top 100 companies had implemented some form of majority voting in director elections. SHEARMAN & STERLING, CORPORATE GOVERNANCE OF THE LARGEST US PUBLIC COMPANIES 4 (2010). As most of the larger public companies have enacted majority voting provisions, the mandatory imposition of majority voting provisions would have affected smaller public companies most directly. For a summary of the arguments against a majority voting standard, see Sjostrom & Kim, *supra*, at 469.

<sup>58</sup> For an extended argument on the merits of democracy in business entities, see DINO FALASCHETTI, DEMOCRATIC GOVERNANCE AND ECONOMIC PERFORMANCE: HOW ACCOUNTABILITY CAN GO TOO FAR IN LAW, POLITICS, AND BUSINESS (2009).

corporation basis, is likely preferable to an opt-out regime, in which the Commission has to guess at an optimal default rule, and where the data indicate that the Commission’s current best guess destroys a statistically significant amount of shareholder wealth.<sup>59</sup>

Why would at least some shareholders be concerned with greater shareholder power? Because larger shareholders with proxy access may use the threat of a proxy fight to extract private benefits from a corporation—perhaps merely by using the proxy as a megaphone for the shareholder’s causes (imposing what Grundfest calls “megaphone externalities”)<sup>60</sup>—or simply to pursue idiosyncratic corporate governance changes that the shareholder (but not management or the majority of the other shareholders) believes are necessary.

Buckberg and Macey provide several arguments against proxy access in a report accompanying the Business Roundtable’s comments on the SEC’s 2009 proxy access proposal.<sup>61</sup> They find that proxy access is unnecessary given numerous effective mechanisms to discipline management, that proxy contests under the pre-Dodd-Frank rules were not prohibitively expensive, and that the SEC’s proposed rules would inefficiently allocate benefits and costs of proxy contests and would not distinguish between the issues associated with expressing disapproval of an incumbent director and the issues associated with identifying, nominating, legitimating, and electing an outside insurgent director, among other reasons. They also argue that an increase in proxy-related costs is a predictable and inevitable result of proxy access:

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<sup>59</sup> Joseph A. Grundfest, *Measurement Issues in the Proxy Access Debate* 3-4 (Rock Ctr. For Corp. Governance, Working Paper Series No. 71, Stan. Univ. L. Sch. L. and Econ. Olin, Working Paper Series No. 392, 2010), *available at* <http://ssrn.com/abstract=1538630>.

<sup>60</sup> Joseph A. Grundfest, *The SEC’s Proposed Proxy Access Rules: Politics, Economics, and the Law* 4 (Rock Ctr. For Corp. Governance, Working Paper Series No. 64, Stan. Univ. L. Sch. L. & Econ. Olin, Working Paper Series No. 386, 2009), *available at* <http://ssrn.com/abstract=1491670>.

<sup>61</sup> See ELAINE BUCKBERG & JONATHAN MACEY, REPORT ON EFFECTS OF PROPOSED SEC RULE 14A-11 ON EFFICIENCY, COMPETITIVENESS AND CAPITAL FORMATION IN SUPPORT OF COMMENTS BY BUSINESS ROUNDTABLE (2009) (stating that risks of the SEC’s proposal include less qualified boards of directors, board members whose interests diverge from maximizing shareholder value, a disincentive to go public, and increasing the cost of capital for U.S. companies).

It is a well-known result in economic theory that when the marginal social cost of an activity exceeds its marginal private cost, as is the case with any subsidy, more of that activity will take place. In the case of the proposed SEC rule, the marginal social cost of a shareholder nominating a director is higher than the marginal private cost because the costs of the contested election are borne in part by the issuer, rather than the nominating shareholder. This subsidy will inevitably increase the number of director nominations by shareholders.<sup>62</sup>

Lowering the cost of proxy access leads to a pernicious result, particularly when the right of access is conditioned upon a relatively low level of shareholder ownership: proxy rules give influence to investors with less to lose from the poor performance of the company and more to gain through private benefits. Even if the dissident shareholders are interested in wealth maximization for all shareholders, Buckberg and Macey present evidence that companies with dissident board members significantly underperform peer companies without dissident directors.

Dodd-Frank's other Subtitle G corporate governance provision, a comply-or-explain provision that would require disclosure on the CEO and chairman of the board of directors (COB) positions, may also have pernicious effects. The policy justification for splitting the two roles is thin. Oded, Palmon and Wald argue that while a management structure in which two executives hold the CEO and COB may facilitate checks and balances and thus may mitigate management agency costs, a management structure in which one person holds both positions provides a clearer set of directives for the companies and facilitates better communication between boards and management.<sup>63</sup> Results from the UK also show that splitting the roles does not appear to produce positive effects. In a recent study, Dahya, Garcia and van Bommel reviewed the performance of publicly listed U.K. companies over a period covering the issuance of the Cadbury Committee's Code of Best Practice, which advocated splitting the CEO/COB positions.<sup>64</sup>

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<sup>62</sup> *Id.* at 8.

<sup>63</sup> Oded Palmon & John K. Wald, *Are Two Heads Better than One: The Impact of Changes in Management Structure on Performance by Firm Size*, 8 J. CORP. FIN. 213, 214 (2002).

<sup>64</sup> Jay Dahya, Laura Galguera Garcia & Jos van Bommel, *One Man Two Hats: What's All the Commotion!*, 44 FIN. REV. 179 (2009).

They found that companies splitting the combined CEO/COB position did not exhibit any absolute or relative improvement in performance when compared to various peer-group benchmarks.<sup>65</sup> These findings are supported by a study by Dey, Engel and Liu.<sup>66</sup> They examined the effects of US firms that had split the CEO/COB position and ones that had not, and noted that there was no significant difference in either the accounting or market return performance. In fact, when firms had a powerful CEO, strong information flows and strong governance, in addition to a combined CEO/COB position, returns were significantly higher than both combined CEO/COB firms without these traits and firms with separate roles for their CEO and COB. They conclude that regulators should be wary about implementing a one-size-fits-all requirement for this position, as some firms appear to benefit from the combined arrangement.

This section has addressed the potentially pernicious effects of the Dodd-Frank Act as stand-alone provisions, but there is also a general concern over what Bainbridge calls the “creeping federalization” of corporate law. Bainbridge argues that:

[T]he uniformity imposed by [the Dodd-Frank Act] will preclude experimentation with differing modes of regulation. As such, there will be no opportunity for new and better regulatory ideas to be developed—no “laboratory” of federalism. Instead, we will be stuck with rules that may well be wrong from the outset and, in any case, may quickly become obsolete.<sup>67</sup>

With respect to corporate governance, the Dodd-Frank Act’s one-size-fits-all governance structures will not reduce either company or systemic risks, and instead will incrementally reduce the flexibility and value of state regulation of public corporation governance. Ribstein notes the irony of establishing a rule that supposedly empowers shareholders, yet

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<sup>65</sup> *Id.*

<sup>66</sup> Aiysha Dey, Ellen Engel, Xiaohui Gloria Liu, *Determinants and Implications of Board Leadership Structure*, UNI. CHI BOOTH SCH. BUS. RES. PAP., (Jun. 2009).

<sup>67</sup> Stephen M. Bainbridge, *The Pernicious Corporate Governance Provisions of the Dodd Bill*, PROFESSORBAINBRIDGE.COM (Apr. 22, 2010, 2:07 PM), <http://www.professorbainbridge.com/professorbainbridgecom/2010/04/the-pernicious-corporate-governance-provisions-of-the-dodd-bill.html>.

at the same time eliminates their ability to choose something other than a federally-mandated proxy structure:

The real problem is that the SEC has barred any possibility for the shareholders or state law to provide for less proxy access than under the new rule. How can a rule that bars shareholders from making certain types of governance rules, either directly or by choosing the state of incorporation, increase shareholder participation in governance?

Perhaps the answer is that shareholders shouldn't participate in governance because they are too easily manipulated and misled and simply don't know what's good for them. Rather, the SEC knows best. . . . Consider the most obvious anomalies: If the shareholders can't be trusted to decrease proxy access, why should they be trusted to increase it? If we fear that managers, even with the new proxy rule, can still manipulate shareholders, then why trust the shareholders to do anything? And if the shareholders can't be trusted, why should the securities laws force firms, at great cost, to inform shareholders so they can participate in the proxy process? In other words, the rule is fundamentally inconsistent with the whole point of the securities laws to provide the disclosure necessary to enable the shareholder to be effective governors of their firms.<sup>68</sup>

*b) The Pointlessness of the Dodd-Frank Act's Corporate Governance Provisions*

Even if one assumes that the Dodd-Frank Act's corporate governance provisions are good policy, given recent trends in state law and the private ordering of corporate governance, the provisions appear to be pointless, rather than pernicious; reminiscent of Cunningham's memorable

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<sup>68</sup> Larry Ribstein, *The SEC vs. shareholders*, TRUTH ON THE MARKET (Aug. 30, 2010, 9:15 AM), <http://truthonthemarket.com/2010/08/30/the-sec-vs-shareholders/>.

characterization of the Sarbanes-Oxley “yawn,”<sup>69</sup> the Dodd-Frank Act might also represent more rhetoric than reform. While the corporate governance provisions are unlikely to produce any significant benefits (and many would argue that Sarbanes-Oxley did not either), the direct costs will certainly be less significant than Sarbanes-Oxley’s. Dodd-Frank’s provisions may simply not have much of an effect on corporate governance.

In the case of proxy access, shareholders in the most important corporate jurisdiction, Delaware, had the ability prior to the enactment of Dodd-Frank to select shareholder proxy for their firms. Delaware General Corporation Law section 112 provides that “[t]he bylaws may provide that if the corporation solicits proxies with respect to an election of directors, it may be required, to the extent and subject to such procedures or conditions as may be provided in the bylaws, to include in its proxy solicitation materials (including any form of proxy it distributes), in addition to individuals nominated by the board of directors, 1 or more individuals nominated by a stockholder. At least in Delaware, private ordering was already possible, making the Dodd-Frank proxy provisions pointless unless it is the case that shareholders are impeded from exercising their right to nominate shareholders under the DGCL. In the adopting release for the proxy access rules, however, the SEC argued that:

corporate governance is not merely a matter of private ordering. Rights, including shareholder rights, are artifacts of law, and in the realm of corporate governance some rights cannot be bargained away but rather are imposed by statute. There is nothing novel about mandated limitations on private ordering in corporate governance.

The SEC then argued that private ordering is less desirable because a “company-by-company shareholder vote on the applicability of Rule 14a-11 would involve substantial direct and indirect, market-wide costs.” A compromise solution—the ability for companies to opt out of the proxy access rules—was rejected because “management can draw on the full resources of the corporation to promote the adoption of an opt-out, while disaggregated shareholders have no similarly effective platform from which to advocate against an opt-out.” Finally, even where

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<sup>69</sup> Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And it Just Might Work)*, 35 CONN. L. REV. 915 (2003).

proxy rights are granted pursuant to a provision like DGCL sec. 112, the SEC noted that “the board of directors is ordinarily free, subject to its fiduciary duties, to amend or repeal any shareholder-adopted bylaw.”

Although I do not believe these arguments carry the burden of proof that would justify such important mandatory governance changes, especially given the pernicious effects outlined by Buckberg and Macey, the importance of this change may prove to be less significant than the arguments against proxy access have suggested. Some hope that this may be the case comes from the Canadian experience with proxy access. Although proxy access is available to investors in Canadian firms, that access is rarely used.<sup>70</sup> The reason, a Canadian lawyer suggests, is that using the corporation’s proxy would put the shareholder activist at “a tactical disadvantage.”<sup>71</sup> If activists use the corporate proxy, they would be limited to the restrictions of the corporate proxy (presumably including word limitations). Effectively, activists tend to view the ability to control the message as worth the costs of a proxy solicitation. The hope that investors will only use proxy access as a means of reducing managerial agency costs is dampened by the likelihood that even if shareholders rarely use proxy access in the U.S, activists may credibly use the threat of proxy access as a lever with corporations to extract private benefits. One means of neutralizing this threat is to make clearer to other shareholders the effects of this leverage. Exposing this leverage, by requiring enhanced disclosures of shareholder involvement in corporate governance matters, may help prevent some of the harmful aspects of proxy access predicted by its detractors.<sup>72</sup>

The provision on the separation of the CEO and chairman roles seems much less likely than proxy access to have an impact on governance since it has already been enacted in principle.<sup>73</sup> Perhaps like the proxy access provision, the CEO-Chairman disclosure provision was included simply to provide legislative protection for the SEC’s rulemaking efforts. Even if this were a new rule, however, it would likely not have a significant

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<sup>70</sup> Lisa Fairfax, *Some Canadian Perspective on Proxy Access*, THE CONGLOMERATE (Mar. 9, 2010, 1:03 PM), <http://www.theconglomerate.org/2010/03/some-canadian-perspective-on-proxy-access.html>.

<sup>71</sup> *Id.*

<sup>72</sup> For a discussion of the effects of shareholder influence and a proposal of possible disclosure rules that would address the enhanced shareholder influence created by the Dodd-Frank Act, see Paul Rose, *Common Agency and the Public Corporation*, 63 VAND. L. REV. 1355.

<sup>73</sup> Dahya, Galguera, Garcia & van Bommel, *supra* note 64, at 180.

effect. In some cases, comply-or-explain sorts of provisions tend to have the effect of mandatory governance rules because of the costs of non-compliance (either through burdensome disclosures or because of the shaming aspect intended by the disclosure). This may be the case, for example, with the disclosure of a code of ethics required under Section 406 of the Sarbanes-Oxley Act. In the case of the separation of the CEO and chairman roles, however, combining the two roles is not intuitively inappropriate; on the other hand, shareholders might reasonably wonder why a company would not have a code of ethics.

### III. CONCLUSION

This essay has briefly reviewed the connection between risk and corporate governance and the specific corporate governance provisions of the Dodd-Frank Act. The corporate governance provisions, covering majority voting for director elections, proxy access, and the separation of the roles of CEO and chairman of the board, seem likely to have one of two possible effects. On the one hand, the provisions may be pernicious—and the proxy access rules seem very likely to fall into this category—in that they further enhance shareholder power without a clear justification for enhanced shareholder power, but more particularly without a justification for shareholder power as a risk management device. Indeed, the Dodd-Frank Act’s corporate governance provisions may work at cross-purposes to the risk management intent of the remainder of the Dodd-Frank Act: the corporate governance provisions operate under the assumption that enhanced shareholder power will result in better monitoring of managerial behavior, which presumably will help to prevent future crisis, but both theory and evidence suggest that diversified shareholders generally prefer companies to take risks that other constituencies (including taxpayers) would not prefer. Empowering shareholders further will not change the nature of the shareholders’ interest in risk-taking since they are limited in their downside risk; if influential shareholders focus on long-term rather than short-term gains, it will be because of market forces, not because they have been empowered by the Dodd-Frank Act.

On the other hand, the Dodd-Frank Act may have very little effect on investor behavior or risk management. This is probably the case for the CEO/COB split provision. Increases in shareholder power over the past years (fundamentally the result of increased federal regulation) have made management responsive—and in some cases probably overly responsive to—shareholder concerns over agency costs. If private ordering is already working, what is the point of imposing strict governance constructs across



the market as a whole, especially when most of the affected firms are victims of, rather than contributors to, the Financial Crisis?

## JUSTIFICATION NORMS UNDER UNCERTAINTY: A PRELIMINARY INQUIRY

Claire A. Hill\*

*People making decisions under uncertainty may need to justify those decisions to their reputational community. This Essay considers when and how the potential need to justify might lead a decision-maker to employ a methodology better suited to yielding a justifiable choice that may not be the best choice. When a decision involves uncertainty, the possible outcomes and probabilities are not known. A broad consensus about a methodology that produces a good decision often may not exist. But norms will often arise as to acceptable methodologies—that is, methodologies that will be accepted as justifiable if justification is needed. The norms instantiate considerable stickiness – after all, the best way to demonstrate that something is (typically) “done” is to show that relevant others “do it.” This Essay identifies a particular pathology associated with the practice of favoring a justifiable decision over a “good” one, and argues that this pathology can have significant negative consequences. The main example discussed is the volume of subprime securities purchased. Other examples include the process by which CEOs are selected, and decisions regarding contract terms in complex business contracts.*

“The acceptability heuristic is, perhaps, the least inspiring strategy for coping with accountability. This strategy does, however, have obvious adaptive value for the individual decision-maker.”<sup>1</sup>

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<sup>1</sup> Philip E. Tetlock, *The Impact of Accountability on Judgment and Choice: Toward a Social Contingency Model*, in 25 ADVANCES IN EXPERIMENTAL SOCIAL PSYCHOLOGY 331, 348 (Mark P. Zanna ed., 1992).

## I. IDENTIFICATION OF THE PROBLEM

Investors bought enormous quantities of subprime mortgage securities when they were the hot new thing; the financial crisis began when the securities plummeted in value. Investors' reasons for buying the securities were not based on a careful appraisal of the securities.<sup>2</sup> Rather, the investors relied on what others said and did, even when their reliance was not warranted.<sup>3</sup> If more investors had done their own appraisals, the crisis might not be as severe. Indeed, if enough investors had done their own appraisals, the crisis might not have occurred. This Essay argues that the strategy investors followed – reliance on others – was adopted more to help them justify to others whatever results their investments yielded than to genuinely arrive at the best substantive decision. This Essay also argues that when enough individuals follow such a strategy, society may suffer.

One might think that the potential need to justify *ex post* should naturally lead to better *ex ante* decisions. After all, the better a decision is *ex ante*, the less likely an *ex post* justification will be needed. But in a class of cases involving decision-making under uncertainty, the potential need to justify may not lead to better decisions. Instead, it may lead to decisions that yield negative externalities and other social costs. It may also prevent the accretion of useful information, as well-worn strategies that provide justification are used in lieu of strategies aimed directly at making the best decision. The enormous volume of subprime securities purchased, and the consequent crisis, provides an important example.

The phenomenon of focusing as much or more on potentially justifying a decision as on making the best decision is exceedingly common. This Essay considers when and how the potential need to justify might lead a decision-maker to employ a methodology better suited to yielding a justifiable choice that may not be the best choice. The intuition is simple to articulate. When a decision involves uncertainty, the possible outcomes and probabilities are not known. A broad consensus about a methodology that produces a good decision often may not exist. But norms will often arise as to *acceptable* methodologies—that is, methodologies that will be accepted as justifiable if justification is needed.<sup>4</sup>

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<sup>2</sup> See generally, MICHAEL LEWIS, *THE BIG SHORT* (2010).

<sup>3</sup> See *id.*

<sup>4</sup> The contrast between decisions supported by “good” justifications and those supported by “acceptable” justifications that are not also “good” justifications unrealistically assumes that there are clear ways to determine what counts as a

The norms instantiate considerable stickiness – after all, the best way to demonstrate that something is (typically) “done” is to show that relevant others “do it.”

Justifications may need to be directed to any or all of the following: courts, regulators, self-regulatory bodies, colleagues, clients, or the “court of public opinion.” What makes a justification acceptable differs for different groups. This Essay addresses justifications to one’s colleagues or clients, or, more broadly, to one’s reputational community, and leaves other focuses of justification to later work. In that regard, the examples used in this Essay relate to business decisions. The phenomenon is not confined to business, but business is a convenient port of entry. Business actors are continually judged by their reputational community, including people in a position to offer rewards such as promotions or bonuses, or punishments such as firing or demotion. The reputational community of such actors has a rich set of norms for acceptable justifications—norms that business actors abide by.

That business actors may “herd” or abide by social norms or established practices is a commonplace observation. This Essay identifies a particular pathology associated with that practice, in disparate but common contexts, decision-makers’ potential need to justify decisions made under uncertainty, and argues that this pathology can have significant negative consequences. The goal of this Essay is to provoke inquiry as to the breadth of the problem identified, as well as possible solutions.

This Essay proceeds as follows: Section 2 articulates the problem. It distinguishes uncertainty from risk, comparing the need for and availability of justifications in both cases. Section 3 discusses the motivating example, the purchase of highly-rated subprime securities by institutional investors. Section 4 discusses several additional examples; one is the process by which CEOs are selected. The other examples involve decisions regarding contract terms, choice of state of incorporation, and the purchase of insurance. Section 5 considers ways in which law contributes to the problem. Section 6 makes preliminary suggestions for solutions. Section 7 concludes.

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“good” decision and methodology. While the assumption is ultimately unrealistic, it is sufficient for purposes of this Essay.

## II. ARTICULATION OF THE PROBLEM

## A. UNCERTAINTY DISTINGUISHED FROM RISK

In *Risk, Uncertainty and Profit*, Frank Knight famously distinguished uncertainty from risk:

...Uncertainty must be taken in a sense radically distinct from the familiar notion of Risk, from which it has never been properly separated. The term "risk," as loosely used in everyday speech and in economic discussion, really covers two things which, functionally at least, in their causal relations to the phenomena of economic organization, are categorically different. . . . The essential fact is that "risk" means in some cases a quantity susceptible of measurement, while at other times it is something distinctly not of this character; and there are far-reaching and crucial differences in the bearings of the phenomenon depending on which of the two is really present and operating. . . . It will appear that a measurable uncertainty, or "risk" proper, as we shall use the term, is so far different from an unmeasurable one that it is not in effect an uncertainty at all. We shall accordingly restrict the term "uncertainty" to cases of the non-quantitative type.<sup>5</sup>

Knight notes that in conditions of uncertainty, "no valid basis of any kind for classifying instances" exists.<sup>6</sup> This statement is, in some meaningful sense, an exaggeration: there is always *some* valid basis for classification.<sup>7</sup> Indeed, a valid basis for classifying instances of

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<sup>5</sup> FRANK KNIGHT, *RISK, UNCERTAINTY AND PROFIT* 19–20 (1921).

<sup>6</sup> *Id.* at 225.

<sup>7</sup> "Classification" as used here is synonymous with "categorization;" the latter term is more commonly used in the literatures dealing most directly with the area, notably psychology. *See generally* Arthur B. Markman & Brian H. Ross, *Category Use and Category Learning*, 129 PSYCHOL. BULL. 592, 592–93 (2003) (providing a definition of "categories"); Kristin E. Hickman & Claire A. Hill, *Concepts, Categories and Compliance in the Regulatory State*, 94 MINN. L. REV. 1151, 1185–98 (2010) (discussing linguistic and legal categories in the context of regulatory regimes); Claire A. Hill, *Beyond Mistakes: The Next Wave of*

*uncertainty* exists. Thus, the difference between risk and uncertainty is, in an important respect, quantitative rather than qualitative. There is a continuum of more-or-less valid bases for “classifying instances.”

At the uncertainty end of the continuum, there are, in Donald Rumsfeld’s famous words, “unknown unknowns.”<sup>8</sup> At the risk end of the continuum, there are (wholly) valid bases for classifying instances: the classification yields an identifiable and determinate set of instances as to which we know the possible outcomes and associated probabilities. Thus, a risk, in the true sense of the word, can easily be assessed using a straightforward arithmetic computation typically known as “expected value.” Few things are at the extreme end of the continuum— an exception is the stylized gambles used in experiments. But many things are close enough. A pool of prime mortgages is (or at least before the financial crisis, was) a notable example. The performance of prime mortgages has been tracked extensively for at least the last 40 years.<sup>9</sup> Of course, notwithstanding its colloquial use to the contrary, “risk” is not synonymous with “high risk.” Treasury securities are technically “risky” although they are commonly referred to (and thought of) as being risk-free or nearly so.

Natural disasters are at the uncertainty end of the continuum. Which is the better classification to enable us to make predictions, the broader set of natural disasters or a subset of specific such disasters? (And: what counts as a natural disaster?) Moreover, even for a classification that is straightforward, considerable uncertainty can exist: how well can we predict the damage hurricanes will cause in 2012? Uncertainty makes it difficult to assess how much to spend insuring against the possibility of all or particular natural disasters, or how much to pay for investments that constitute bets on the occurrence of such disasters.<sup>10</sup>

In an idealized (and of course highly unrealistic) paradigm of decision-making, these difficulties do not arise. A decision maker can

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*Behavioral Law and Economics*, 29 QUEEN’S L.J. 563, 573–76 (2004) (discussing the relevance of categorization for law and economics and behavioral law and economics).

<sup>8</sup> Michael R. Gordon, *Rumsfeld, A Force for Change, Did Not Change With the Times Amid Iraq Tumult*, N.Y. TIMES, Nov. 9, 2006,

<sup>9</sup> See Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061, 1119 (1996).

<sup>10</sup> Investments that constitute bets on the occurrence of natural disasters are called “catastrophe bonds” or colloquially, “cat bonds.” See *Glossary of Economic and Finance Terms*, FREDDIE MAC, [http://www.freddiemac.com/smm/a\\_f.htm#C](http://www.freddiemac.com/smm/a_f.htm#C). (last visited Sept. 28, 2010).

perform an accurate expected value computation – she chooses among some determinate set of identified options, and knows the possible outcomes and associated probabilities for each option. The strategy is a good one from a substantive perspective. For the same reason, it is readily justifiable.<sup>11</sup> Consider a choice between option A, offering a 10% chance of a \$200,000 payoff and a 90% chance of a \$4,000 payoff, and option B, offering a 99.5% chance of a \$12,000 payoff and a .5% chance of a \$1000 payoff. A choice of option A would be easy to justify:  $(.10 \times \$200,000 + .90 \times \$4,000) > (.995 \times \$12,000 + .005 \times \$1,000)$ .<sup>12</sup> Even a choice of B is justifiable, especially for a one-time gamble – the decision-maker could claim risk-aversion.<sup>13</sup>

Using this strategy requires that the outcomes and probabilities of each option are known (and even more heroically, that the options

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<sup>11</sup> See generally MATTHEW D. ADLER & ERIC A. POSNER, NEW FOUNDATIONS OF COST-BENEFIT ANALYSIS 62 (2006). This Essay uses “cost benefit analysis” and “expected value” as though they were synonymous; while they clearly are not, for purposes of the argument here, they can be treated as such.

<sup>12</sup> Of course such a simple computation won’t often be possible. Even if a computation of this sort is possible, the numbers will almost certainly be open to argument.

<sup>13</sup> Of course, proceeding in this manner is not infrequently controversial. One common objection is that this approach is cold or unfeeling, or constitutes trying to value something that inherently cannot be valued. See FRANK ACKERMAN & LISA HEINZERLING, PRICELESS: ON KNOWING THE PRICE OF EVERYTHING AND THE VALUE OF NOTHING 35–40 (2004). For a discussion of the issue in the context of environmental law, see Richard L. Revesz, *The green community should mend, not work in vain to end, cost-benefit analysis*, GRIST, (May 8, 2008, 09:12 AM), <http://www.grist.org/article/cost-benefit-environmentalism/> (promoting the use of cost-benefit analyses in the context of environmental regulation); Lisa Heinzerling, *Lisa Heinzerling responds to Richard Revesz on cost-benefit analysis*, GRIST, (May 14, 2008, 4:49 PM), <http://www.grist.org/article/cost-benefit-environmentalism-an-oxymoron/> (arguing against the use of cost-benefit analysis in the area of environmentalism); Richard L. Revesz, *Richard Revesz responds to Lisa Heinzerling, defending cost-benefit analysis*, GRIST, <http://www.grist.org/article/a-tool-in-the-toolbox> (June 5, 2008, 06:21 AM) (responding to Lisa Heinzerling’s posting on Grist). A related objection is that quantification makes a decision seem more well-supported than it is – to overstate, the inputs into the quantification may be “garbage,” such that “garbage in, garbage out.” See Claire A. Hill, *Law and Economics in the Personal Sphere*, 29 LAW & SOCIAL INQUIRY 219, 224 (2004). But, in principle it is a respectable method, and may come closest to commanding the most general conceptual acceptance. Certainly, there is no obvious competitor.

themselves are known), or at least known well enough. What if they are not? How do we know what our choice set consists of? Even if we know what the set consists of, how do we assess possible outcomes and the associated probabilities for each member of the set? In fact, we almost never “know” the appropriate elements of the canonical expected value computation.<sup>14</sup> But not infrequently enough of a consensus exists as to those elements, so that the computation can be done and defensibly used.

Any decision may need justification. Many factors bear on the possibility that justification is required, including the likelihood and nature of the possible bad outcomes (or foregone good outcomes). But closer to the risk end of the spectrum, there is, in principle, a good and acceptable justification in the form of expected value. Of course, many decisions raise issues about what can and should be quantified, and what kinds of trade-offs are acceptable.<sup>15</sup> Consider decisions about whether to proceed with a mass immunization program when the best evidence indicates that some small number of people will suffer serious side effects from the immunization.<sup>16</sup> A particular decision may make a controversial assumption about how to quantify the “cost” of the side effects. But the assumption will be used to make the decision and to justify it: the good justification and the acceptable justification are one and the same.

Closer to the uncertainty end of the continuum, we may not have a decision methodology that is as accepted or good as expected value. By definition, in cases of uncertainty, we cannot compute probabilities and outcomes. The methodology thus is not available to help make the decision or to provide a justification. How might a decision-maker react? There is voluminous literature demonstrating the existence of “uncertainty aversion,” or, as it is sometimes called, “ambiguity aversion.”<sup>17</sup> People do

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<sup>14</sup> A computation of risk can be quite complex: we may only know second-order probabilities, and even those only within certain ranges. But we may know enough to make a computation in which we have significant confidence. If the decision is one of a series of like decisions, we may have considerable confidence in the aggregate results.

<sup>15</sup> ACKERMAN & HEINZERLING, *supra* note 13.

<sup>16</sup> See, e.g., CTRS. See, e.g., UPDATE: VACCINE SIDE EFFECTS, ADVERSE REACTIONS, CONTRAINDICATIONS, AND PRECAUTIONS RECOMMENDATIONS OF THE ADVISORY COMMITTEE ON IMMUNIZATION PRACTICES (ACIP), CTRS. FOR DISEASE CONTROL & PREVENTION (1996), available at <http://www.cdc.gov/mmwr/preview/mmwrhtml/00046738.htm>.

<sup>17</sup> See, e.g., Uzi Segal & Alex Stein, *Ambiguity Aversion and the Criminal Process*, 81 NOTRE DAME L. REV. 1495, 1495 (2006); Craig R. Fox & Amos



not like uncertainty; they will pay money to avoid choosing in conditions of uncertainty.<sup>18</sup> Business actors do not have this option. They must make a choice.

A decision-maker who faces uncertainty knows she may have to justify her decision. Without a sound decision-making methodology to get the best decision, without a way to assess how likely it is that the justification will be needed, and especially when the downside of a bad decision is potentially high, she will focus significantly on seeking a justification that would be accepted by the relevant reference group.

In the stylized case of risk, there is by hypothesis a known and accepted way to make the best substantive decision – expected value.<sup>19</sup> The decision-maker may have to be ready to justify her decision, especially if it potentially carries a significant downside risk. The need to justify does not, however, change the decision she makes. Her decision-making methodology should yield the best decision as well as the most justifiable decision. By contrast, in the stylized case of uncertainty, there is no known and accepted way to make the best substantive decision. The decision-maker cannot accurately assess the probability that she will have to justify the decision, but she cannot rule out that it might be high. She therefore makes a decision that she is able to justify. What kinds of

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Tversky, *Ambiguity Aversion and Comparative Ignorance*, 110 Q.J. ECON. 585, 585 (1995). A search on ssrn.com for “ambiguity aversion” in the title, abstract or keywords yields 110 papers.

<sup>18</sup> See Daniel Ellsberg, *Risk, Ambiguity and the Savage Axioms*, 75 Q. J. ECON. 643 (1961), (the seminal article addressing choices under conditions of uncertainty.). See also Marciano Siniscalchi, *Ambiguity and Ambiguity Aversion*, in THE NEW PALGRAVE DICTIONARY OF ECONOMICS 138 (Steven N. Durlauf & Lawrence E. Blume eds., 2d ed. 2008).

<sup>19</sup> Of course, there are few cases of pure risk or uncertainty. Moreover, the situations in which an expected value computation is feasible, meaningful and sufficiently uncontroversial are few and far between. Still, expected value is, as a matter of rhetoric, a paradigmatic decision-making process in the realm of business and has significant force in other realms, as well. That being said, in the political realm—the realm which provides Tetlock’s framework of accountability in Tetlock, *supra* note 1, - expected value might almost never be accepted in the broader community to which a politician is accountable because the community is intractably heterogeneous, the methodology might be too technical, there exists insufficient consensus on the components of the computation, and, probably most significantly, there may be many people who are either disingenuous in their non-acceptance or simply regard the outcome as the only thing of importance, such that a bad outcome cannot be justified.

decisions would a decision-maker be best able to justify? Decisions that invoke history or authority seem well-suited to become the norm<sup>20</sup> for the relevant community.<sup>21</sup> Indeed, taking a step back, it should not be surprising that such norms develop and persist: Decision-makers in a reputational community are similarly situated vis-a-vis one another: they all benefit from the existence of norms by which they can minimize their expected costs. The result can be path dependence,<sup>22</sup> stickiness,<sup>23</sup> herd behavior,<sup>24</sup> and even groupthink.

#### B. JUSTIFICATION, ACCOUNTABILITY AND THE ACCEPTABILITY HEURISTIC

The foregoing discusses how people may justify less-than-good outcomes of their decisions. This Section elaborates on the functions and form of a justification.

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<sup>20</sup> On social norms generally, see H. Peyton Young, *Social Norms*, in THE NEW PALGRAVE DICTIONARY OF ECONOMICS, *supra* note 18, at 647.

<sup>21</sup> What determines community boundaries, and how norms are adopted and maintained in communities, are clearly relevant to the issues this Essay addresses, but are beyond its scope. See generally Claire A. Hill, *A Comment on Language and Norms in Complex Business Contracts* 77, CHI. KENT. L. REV. 29 (2002) (discussing the boundaries of the complex business transacting community).

<sup>22</sup> See e.g., Steven N. Durlauf, *Path Dependence*, in THE NEW PALGRAVE DICTIONARY OF ECONOMICS, *supra* note 18, at 318.

<sup>23</sup> The paradigmatic use of the term “stickiness” is in the context of wages and prices. See THE ECONOMIST, <http://www.economist.com/research/Economics/alphabetic.cfm?TERM=STICKY%20PRICES#stickyprices> (last visited Sept. 28, 2010). The term has, however, become broadly used in economics to refer to behavior that changes more slowly than the standard forces in economics, such as supply and demand, might predict.

<sup>24</sup> See Sushil Bikhchandani, David Hirshleifer & Ivo Welch, *A Theory of Fads, Fashion, Custom, and Cultural Change as Informational Cascades*, 100 J. POL. ECON. 992 (1992) (the seminal paper on herding and the related subject of information cascades in finance). There is a rich literature on the subject. See, e.g.,

Sushil Bikhchandani, David Hirshleifer & Sushil Bikhchandani, *Information Cascades*, in THE NEW PALGRAVE DICTIONARY OF ECONOMICS, *supra* note 18; Andrea Devenow & Ivo Welch, *Rational Herding in Financial Economics*, 40 EUR. ECON. REV. 603 (1996); Torben Lütje, *To Be Good Or To Be Better: Asset Managers’ Attitudes Towards Herding*, 19 APPLIED FIN. ECON. 825 (2009); David Hirshleifer & Siew Hong Teoh, *Herd Behaviour and Cascading in Capital Markets: A Review and Synthesis*, 9 EUR. FIN. MGMT 25 (2003); Ivo Welch, *Herding Among Security Analysts*, 58 J. FIN. ECON. 369 (2000).

Justifications are needed when people are, in Philip's Tetlock term, "accountable."<sup>25</sup>

Expectations of accountability are an implicit or explicit constraint on virtually everything people do . . . . Failure to act in ways for which one can construct acceptable accounts leads to varying degrees of censure, depending on the gravity of the offense and the norms of the society. Although one can make a powerful case for the universality of accountability, the specific norms and values to which people are held accountable vary dramatically from one culture or time to another.<sup>26</sup>

Tetlock sets forth a taxonomy of strategies for coping with accountability, including use of the "acceptability heuristic."<sup>27</sup> According to Tetlock, people "adopt positions likely to gain the favor of those to whom they feel accountable (a coping strategy labeled here as the acceptability heuristic)."<sup>28</sup> The acceptability heuristic is clearly a norm in the relevant community. The heuristic has some benefits for both the individual and groups to which the individual belongs.<sup>29</sup> Moreover, individuals are less likely to make certain mistakes if doing so would not pass muster with the person to whom they are accountable.<sup>30</sup> But it also can have some "highly dysfunctional effects, from both an individual and an organizational perspective. The acceptability heuristic implies that decision-makers can be no better as well as no worse than the constituencies to whom they are accountable."<sup>31</sup>

This Essay articulates a particular pathology within the broader phenomenon Tetlock describes. Uncertainty yields a need for justification, but precludes "good" justifications. The community facing decisions made under uncertainty develops norms of acceptable justifications (which are

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<sup>25</sup> Tetlock, *supra* note 1.

<sup>26</sup> *Id.* at 337 (citations omitted).

<sup>27</sup> *See id.* at 348–51.

<sup>28</sup> *Id.* at 340 (explaining why people might adopt the acceptability heuristic, Tetlock characterizes it as a "least effort solution" and notes that "[a]ll other things being equal, people prefer [such] solutions.")

<sup>29</sup> *Id.* at 349.

<sup>30</sup> *Id.*

<sup>31</sup> Tetlock, *supra* note 1, at 349.

“acceptability heuristics”).<sup>32</sup> These justifications rely too much on history, authority, and present practices, which yield bad decisions that perpetuate themselves.<sup>33</sup> The decisions at issue may be all made in the same time period, as was the case with the purchase of subprime securities. Or they may be made at different times, as in the CEO selection example and the other examples of “sticky” corporate practices. There may be many individuals involved, or comparatively few. The individuals may be acting in ways that favor their own interests at the expense of that of their principal, typically their employer. Or they may be acting in ways congruent with their employer’s interest. In all of these cases, the decisions yield real social costs – sometimes very large ones.

### III. THE MOTIVATING EXAMPLE

The example motivating this Essay arises from the financial crisis. Money managers bought huge volumes of subprime securities, apparently without doing sufficient investigation.

The decision as to whether an investment is worthwhile necessarily involves making assumptions about the future. There will always be an enormous amount we do not know, but we can sometimes have enough information to provide a good basis for a decision. An investor purchasing US Treasury securities can be well assured that she will be timely and fully repaid. (Given the state of the economy, maybe she shouldn’t be!). If an investor lends money to Bernie Madoff today, while he is in jail and there are presumably many superior claims on his assets,<sup>34</sup> the investor is unlikely to be repaid. Even though nobody can fully predict the future, it can sometimes be predicted well enough to enable a person making an investment decision to do so with great confidence.

An investor making an investment decision assesses how she expects the investment to perform. Canonically, she considers the possible outcomes and associated probabilities.<sup>35</sup> How much will the investment pay off in good and bad states of the world? How likely are these respective states? It is immediately obvious that the more of a basis one has for these determinations, the better one’s valuation will be. It is also

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<sup>32</sup> See *id.* at 340.

<sup>33</sup> See *id.* at 349–50.

<sup>34</sup> See Diana B. Henriques, *Claims Total Over 15,400 in Fraud by Madoff*, N.Y. TIMES, July 9, 2009, at B3.

<sup>35</sup> See *id.*

obvious that, all else being equal, the newer and more complex the instrument, the less of a basis one is likely to have.

Subprime mortgage securities and credit default swaps became very popular investments in a short period of time, notwithstanding that they were new and highly complex instruments.<sup>36</sup> This is puzzling. It is one thing for consumers to stand in line all night to buy iPhone4,<sup>37</sup> but sophisticated institutional investors are not supposed to respond to trends simply by chasing them. They also are not supposed to chase trends they do not understand. These investors are now saying, with some plausibility, that they never understood the investments.<sup>38</sup> A companion paper discusses this puzzle and provides an explanation:

Investors bought complex securities they could not properly value. Why did they pay such high prices? One might think that they would instead discount for uncertainty and demand a premium to compensate them in case they were buying a lemon. Perhaps investors thought the lemon securities had been sweetened because of the sellers' stake in their reputation—sellers, not wanting to risk the loss of reputation and future business, would do their best not to sell lemon securities. But an explanation relying on the reputational stake of the sellers – the investment banks – is insufficient. The time horizons of many individuals selling on behalf of investment banks are far shorter than those of their employers. Investment banks have failed to sufficiently constrain the behavior of these individuals. Moreover, it is generally known that the investment banks themselves sometimes put their own interests ahead of customers'.

Perhaps the investors were simply unfaithful agents making investments for others. They could have made

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<sup>36</sup> See Gary B. Gorton, *The Panic of 2007*, 3-4, 9, 20-30 (Nat'l Bureau of Econ. Research, Working Paper No. 14358, 2008), available at <http://www.nber.org/papers/w14358>.

<sup>37</sup> Dawn Kawamoto, *iPhone 4 Draws Long Lines, Entrepreneurs and Expectations of 'Wow!'*, DAILYFINANCE, June 23, 2010, <http://www.dailyfinance.com/story/iphone-4-draws-early-lines-entrepreneurs-and-expectations-of-w/19527671/>.

<sup>38</sup> See generally LEWIS, *supra* note 2.

self-interested decisions to get a quick payoff in the form of fees or short-term results, calculating that the payoff would exceed any long-term financial or reputational cost. This explanation does not work either: it leaves unanswered the question of why the ultimate investors would not have chosen better agents or monitored them more carefully...

Perhaps the investors simply relied on the rating agencies' AAA ratings for the securities? This also seems unlikely, given that Enron was scarcely in the distant past, and that the securities offered higher yields than other AAA-rated securities, indicating that they were of lower quality. Moreover, during the latter part of the period in which subprime securities were popular investments, the securities' low quality became sufficiently evident that reliance on rating-agency ratings became progressively less tenable. ...

The most satisfactory explanation for why investors did not demand a much larger lemons premium lies in the incentives for "herding" among agents who made investment decisions for others. Investors (and markets) compare investment managers to other investment managers. A manager's best strategy, therefore, may be to do what her peers do regardless of whether the manager believes her peers are a reliable source of information about the quality of the investment decision.<sup>39</sup>

These investors could have invested in ultra-conservative instruments, but such a choice would lack an "accepted" justification – that is not what their peer money managers "do." For that matter, it would also lack a "good" justification: a justification based on the merits of the decision and the methodology used. Investors were hired for their supposed expertise in investment selection – an expertise which was to

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<sup>39</sup> Claire A. Hill, *Why Didn't Subprime Investors Demand A (Much Larger) Lemons Premium?*, 74 LAW & CONTEMP. PROBS. 101, 102-4 (2011) (omitted).

yield expected returns above those of an insured bank deposit or Treasury instrument.

Doing what their immediate peers (other money managers) did – buying an investment crafted by other peers (the big investment banks with involvement from their lawyers and vetted by still other peers, the rating agencies) – was “accepted.” The money managers may also have believed their peers knew what they were doing, that subprime mortgage securities were sufficiently similar to the historically successful prime mortgage securities, that housing prices would go up forever, and that brilliant financial structuring could vastly minimize risk while keeping reward high. Whatever the money managers believed about how the instruments would perform, they knew the instruments’ performance (and their own performance as money managers) was subject to considerable uncertainty. Thus, they cared a great deal about the potential need for justification. For money managers, justifying their decisions on the bases that their peers performed no worse would be easier than justifying doing far worse because they missed out on the hot new thing.<sup>40</sup> We know the outcome of these “safe” decisions (for the money managers): the financial crisis.

#### IV. OTHER EXAMPLES

This section presents several additional examples. In these examples, decision-makers use methodologies that the relevant community uses, where there is significant reason to suppose that they do not necessarily yield the best substantive decision. One example is selection of the CEO. The other examples are of choice of state of incorporation, providing for remote contingencies in a complex business contract, and public company purchases of insurance. I discuss each example below. In a recent article, I discussed another example related to my motivating example here: the choice of two (or, in more recent years, two of three) particular rating agencies for a debt issuance. I argued that a “CEO may be second guessed if he does not get two ratings [one from Moody’s and one from Standard & Poor’s] and the offering is disappointing; a downside

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<sup>40</sup> This ignores the contrarians who made bets against such securities and others who simply didn’t get involved on either side. Such investors existed, but there were comparatively few, such that subprime securities came to be dangerously overvalued. *See generally* LEWIS, *supra* note 2.

for not abiding by the norm is far more likely than any upside from flouting it.”<sup>41</sup>

#### A. CEO SELECTION

Another example where accepted justifications are sought as much or more than good decisions (with “good” justifications) is the selection of CEOs for larger companies – companies watched by the markets because market participants have a significant stake in the companies’ performance. How such companies will perform is uncertain for many reasons. The economy’s performance is hard to predict, as are other potentially significant factors, such as natural and man-made disasters. Industry-specific factors and the behavior of a company’s competitors are often unpredictable. If the company does badly, those who selected the CEO may be criticized.<sup>42</sup> Thus, decision-makers may be highly influenced by the potential need to justify when making their decisions as to who will be CEO.<sup>43</sup> According to Rakesh Khurana, a leading scholar in the field:

[B]oards employ extremely limiting criteria to define the pool of eligible candidates. These criteria, which are loosely (if at all) coupled to the specific strategic challenges facing the firm, are adopted largely with the intention of producing a candidate who will be seen as legitimate by external constituents, namely, financial analysts and the business media. . . . Because the directors and candidates involved in external CEO search are embedded in a community of overlapping business and social relationships, they are particularly sensitive to

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<sup>41</sup> Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L. Q. 43, 61 (2004). Fitch also became an acceptable source of one of the two ratings. See Claire A. Hill, *Why Did Rating Agencies Do Such A Bad Job Rating Subprime Securities?*, 71 PITT. L. REV. 585, 600-602 (2010).

<sup>42</sup> See, e.g., Micheline Maynard, *At G.M.’s Helm or Going Under?*, N.Y. TIMES, Mar. 29, 2006 (describing the pressure placed on the board of General Motors when their choice for CEO underperformed in the position).

<sup>43</sup> See, e.g., RAKESH KHURANA, *SEARCHING FOR A CORPORATE SAVIOR: THE IRRATIONAL QUEST FOR CHARISMATIC CEOS* 29–36 (2002) (discussing the role of justification in corporate searches for new CEOs).



maintaining the appearance of propriety in the conduct of the search among their peers.<sup>44</sup>

Each time a prominent company needs a CEO, it chooses from the same small pool of candidates. This seems to be the accepted modus operandi, if the company does badly under the new CEO, it permits those involved to point to the process they followed, and be therefore absolved from responsibility for the results of their decision. Khurana seems to intimate that good quality is at least a necessary condition to be in the pool of candidates.<sup>45</sup> But perhaps good quality is not necessary – it may be that previously being a CEO is sufficient.<sup>46</sup>

One might think that some past performances are so bad that they should disqualify a possible candidate. If that is so, how can we explain Robert Nardelli's selection as the head of Chrysler after his performance at Home Depot?<sup>47</sup> In 2006, Joe Nocera of the New York Times wrote:

Mr. Nardelli . . . has become this year's version of Mr. Overpaid C.E.O. He's earned this status, in part, by the sheer sum of money his board has awarded him in the five years since he was recruited from General Electric to take over Home Depot: \$245 million, including \$37.1 million just this last year. At the same time, Home Depot's stock has fallen 12 percent, while shares of its chief competitor, Lowe's, have risen 173 percent. You've heard of pay for performance? This is the classic definition of pay for pulse.<sup>48</sup>

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<sup>44</sup> *Id.* at 29, 36.

<sup>45</sup> *See id.* at 27–30.

<sup>46</sup> This, of course, is an overstatement – a CEO who is discovered committing a massive fraud probably is no longer in the pool of acceptable CEOs. If he is in jail, he is probably unavailable. “Chainsaw Al” Dunlap did not see a great demand for his services after his disastrous and criminal stewardship of Sunbeam. *See* JOHN A. BYRNE, CHAINSAW: THE NOTORIOUS CAREER OF AL DUNLAP IN THE ERA OF PROFIT-AT-ANY-PRICE 350 (1999).

<sup>47</sup> *See* Joe Nocera, *The Board Wore Chicken Suits*, N.Y. TIMES, May 27, 2006.

<sup>48</sup> *Id.*

Home Depot ousted Mr. Nardelli in January of 2007.<sup>49</sup> He became head of Chrysler in August of 2007, hired by Chrysler's owner, the private equity fund Cerberus, and resigned in April of 2009 as Chrysler entered Chapter 11 bankruptcy, returning to Cerberus.<sup>50</sup> Of course, Nardelli headed Chrysler while the economy was in crisis. We cannot know whether he did a good job; perhaps someone else would have done worse. What is important is that previously being the CEO at Home Depot seems to have been sufficient for Nardelli to obtain another CEO job notwithstanding that he had engendered considerable hostility for his lackluster performance and high pay package.

The strategy of choosing a new CEO from a small pool of present or former CEOs is problematic for many reasons. First, the strategy may not yield the best CEO: another person might have been better.<sup>51</sup> Second, the strategy probably contributes to the high level of CEO compensation overall.<sup>52</sup> It helps perpetuate the illusion that CEO candidates are scarce,<sup>53</sup> and amplifies the resonance of a new CEO's argument that he must be above the median of his comparison group and therefore should be paid

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<sup>49</sup> See Michael Barbaro, *Embattled Chief Executive Resigns at Home Depot*, N.Y. TIMES, Jan. 3, 2007.

<sup>50</sup> See Bill Vlasic, *Chrysler Chief Says He Believes He Has Saved the Automaker*, N.Y. TIMES, May 1, 2009, at B5. It is interesting, too, that Mr. Nardelli's new employer was a private equity fund whose own financial interests were at stake. Mark Clothier, *Chrysler's Nardelli To Rejoin Cerberus Without Golden Parachute*, BLOOMBERG, May 1, 2009, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aQ.PiZK2OzH0>. Who did they need to justify their hiring decision to? In the community that includes private equity funds, there may be far more incentive to try to make the best judgment and far less reason to use a methodology importantly motivated by its justifiability. But the fund does have some agents too. They have their own often-large financial stakes, but they may face the same constraints as other agents in needing to justify what they do. The fund itself may also need justification to its investors if it does not perform as well as its peers.

<sup>51</sup> See KHURANA, *supra* note 43, at 25. How the market perceives the new CEO and what it says about the company to choose and gain her services, may influence how well the company does and hence, how successful the CEO "is" or seems to be. This might seem to complicate the story that the company is losing out when it hires the CEO chosen using the accepted strategy rather than the CEO who would have been chosen because of his skill set. Khurana suggests, however, that the market perception and its effects will fade over time.

<sup>52</sup> *Id.* at 30.

<sup>53</sup> See *id.* at 30 n.18.

accordingly.<sup>54</sup> Third, the strategy perpetuates the reigning narrative that a particular person – a “charismatic” CEO, in Khurana’s words – can save the company.<sup>55</sup> CEOs may have a far smaller effect on the performance of their companies than the narrative suggests – the reigning narrative is probably a myth.<sup>56</sup> Finally, this strategy “restricts access to the CEO position to those who fit certain socially defined criteria.”<sup>57</sup>

In sum, if this depiction is correct, firms expend considerable energy and money chasing a myth. Firms do this in significant part to play to an outside audience.<sup>58</sup> Chasing the myth may also serve to perpetuate it. Going down this mistaken path also prevents accretion of useful knowledge regarding CEO search methodologies and desirable CEO characteristics, as the same approach continues to yield what are arguably less than satisfactory results.<sup>59</sup>

#### B. PROVIDING FOR REMOTE CONTINGENCIES IN COMPLEX BUSINESS CONTRACTS

Complex business contracts are notoriously long and filled with legalese. One significant contributor to their length is provisions relating to remote contingencies. An illustration is found in a memorable “melodrama in three acts” in *Anatomy of a Merger*,<sup>60</sup> a book by James Freund, a leading mergers and acquisitions lawyer. In one scene in the melodrama, the senior lawyer chastises the junior lawyer’s first draft of an acquisition agreement:

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<sup>54</sup> See *id.* at 30.

<sup>55</sup> See *id.* at 20.

<sup>56</sup> *Id.* at 21 (“The widespread, firmly held belief in the overriding importance of the CEO is all the more noteworthy considering that there is no conclusive evidence linking leadership to organizational performance.”). See also Noam Wasserman et al., *When Does Leadership Matter? The Contingent Opportunities View of CEO Leadership* 6–7 (Harvard Univ. Strategy Unit, Working Paper No. 02-04, 2001), available at [http://ssrn.com/abstract\\_id=278652](http://ssrn.com/abstract_id=278652) (arguing that the potential influence of a CEO fluctuates over time and is situation-specific).

<sup>57</sup> KHURANA, *supra* note 43, at 49..

<sup>58</sup> See *id.* at 20–21.

<sup>59</sup> See *id.* at 21 (“[B]oards find themselves trapped in an infinite loop of dashed expectations and CEO churn.”).

<sup>60</sup> JAMES C. FREUND, *ANATOMY OF A MERGER: STRATEGIES AND TECHNIQUES FOR NEGOTIATING CORPORATE ACQUISITIONS* 479-540 (1975).

And then, in the one place you *did* a little thinking, Pete, it seems to me you went too far. I know it's *possible* that they'll repeal the Copyright Act some day, but it doesn't really rise to a level of probability sufficient to warrant three pages of provisions conditional upon that event.<sup>61</sup>

In this situation, Pete removes the provision. The senior lawyer, Freund's alter ego, is in my experience quite idealized. In my years as a lawyer, nobody questioned such provisions, and they were therefore never removed. This is one important reason why contracts have gotten appreciably larger over time. The process by which complex business contracts are written involves starting with a "form" – a document used in a previous transaction. Contract drafters change only what is inapt; they do not remove what is unlikely to be needed. In *Why Contracts Are Written in Legalese*, I explained that:

[in the course of the transaction or its aftermath,] [t]hings may go wrong for many reasons. If they do, clients may blame their lawyers, and senior lawyers may blame their juniors, regardless of where fault lies. And lawyers may worry more than is warranted that things will go wrong and that they will be blamed. Finally, because the form is one's point of departure, its provisions necessarily have a mantle of correctness; deviations have to be, in a sense, "justified." Things already written down come pre-legitimized – not just in the political sense that there's no payoff in challenging them, but also in the psychological sense that they "look like they belong." As a result, deviations from the form, especially more structural or innovative deviations, are disfavored. Necessary changes to use the form in the new transaction are more apt to be as limited as possible to "do the job." Deletions generally must meet a high threshold of justification: omitting a provision because it doesn't do much, but does clutter up

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<sup>61</sup> *Id.* at 500-01, also quoted in Claire A. Hill, *Why Contracts Are Written in Legalese*, 77 CHI-KENT L. REV. 59, 63 (2001).

the form, rarely suffices. But inclusion of new boilerplate that doesn't seem to help but couldn't hurt requires much less justification. Contracts get progressively longer and more cumbersome, and usually not to any positive end.<sup>62</sup>

The social costs of overly long and technical complex business contracts are of course much smaller than the social cost of the excess purchases of subprime securities. And they mostly fall on parties who have in a sense agreed to bear them. But the costs are not insignificant. The extra resources spent in drafting, reading, negotiating, printing, and reviewing contracts over and above what would be needed if the contracts were leaner are fairly large, especially given the billing rates of the lawyers at issue and the value of the time of top-level company officials who may review them; companies pass these costs onto their customers. And of course the longer and more complicated the contract, the more opportunities and costs arise for litigation. Moreover, litigation costs also are borne by taxpayers, who pay for courts.

#### C. OTHER EXAMPLES: "STICKY" BUSINESS PRACTICES

Consider the choice to incorporate in Delaware and the choice of a public company to buy insurance. A good argument can be made that the decision-makers are influenced more by justification than by trying to make the best possible decision from a substantive perspective.

##### 1. Delaware Incorporation

Why do so many companies incorporate in Delaware? Very few companies conduct business in Delaware, yet more than half of all public companies are incorporated there.<sup>63</sup> A great deal of literature exists on this subject.<sup>64</sup> Other states would like to attract incorporation business; there

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<sup>62</sup> Hill, *supra* note 61, at 76.

<sup>63</sup> See Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition Over Corporate Charters*, 112 YALE L.J. 553, 554 (2002); *About Agency*, STATE OF DELAWARE, <http://corp.delaware.gov/aboutagency.shtml> (last updated May 27, 2010).

<sup>64</sup> See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991); ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993); Lucian Arye Bebchuk, Alma Cohen & Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law?*, 90 CALIF.

have been efforts along those lines, but none that have made an appreciable dent in Delaware's market share.<sup>65</sup> One explanation, complementary to many of the explanations in the literature, focuses on justification. At elite law firms, incorporating new corporations in Delaware is the default norm. A lawyer attempting to deviate from the norm would have to explain and justify her decision. Incorporation is typically done by lower-level attorneys. Thus, the explanation would likely need to be made to the senior attorney. Such firms' clients tend to include many people who study the law firm's work product carefully; thus, the unusual choice would have to be explained and justified to a client as well. A typical reason given for incorporating in Delaware is that the Delaware judiciary is better suited to resolving corporate disputes: it is more sophisticated and has a quicker timeline. But very few cases go to court, and many courts follow Delaware corporate law.<sup>66</sup> What seems likely is overall "stickiness" based on the comfort of everyone involved with Delaware law and procedure. Decision-makers do not really investigate alternatives; other states may thus not try

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L. REV. 1775 (2002); Lucian Arye Bebchuk and Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168 (1999); Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992); William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L. J. 663 (1974); Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525 (2001); Daniel R. Fischel, *The 'Race to the Bottom' Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913 (1982); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL. STUD. 251 (1977); Ralph K. Winter, *The "Race for the Top" Revisited: A Comment on Eisenberg*, 89 COLUM. L. REV. 1526 (1989) [hereinafter Winter, *Comment*].

<sup>65</sup> How much other states try to get incorporation business is a matter of considerable debate. It is conventionally argued that other states do compete to get incorporation business. See, e.g., Winter, *Comment*, *supra* note 63; ROMANO, *supra* note 64; Fischel, *supra* note 64. Some scholars argue that they do not try much to get incorporation business because they know they will not succeed against Delaware. See, e.g., Bebchuk & Hamdani, *supra* note 63. One state recently attempting to get incorporation business is North Dakota. See Larry Ribstein, *The North Dakota Experiment*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Apr. 23, 2007, 11:48 PM), <http://blogs.law.harvard.edu/corpgov/2007/04/23/the-north-dakota-experiment>.

<sup>66</sup> See, e.g., *Hilton Hotels Corp. v. ITT Corp.*, 978 F. Supp. 1342, 1345-46 (D. Nev. 1997).

as hard to provide them,<sup>67</sup> potentially setting up a self-reinforcing dynamic. In the typical corporate context involving complex business transactions, there is virtually no chance of being second-guessed and punished for a choice to incorporate in Delaware unless there is a specific, known reason to make a different choice. By contrast, the chance of being second-guessed and punished for a choice to incorporate in another jurisdiction without some affirmative reason for doing so may very well be punished.<sup>68</sup>

## 2. Public Company Purchase of Insurance

Why would public companies buy insurance? A great deal of literature exists on the subject.<sup>69</sup> The starting point is that such companies should be risk-neutral, and therefore should not spend money on insurance premiums. It must cost more to buy insurance than the expected amount of any payout the insurance company would make.<sup>70</sup> The purchase of insurance is therefore a puzzle requiring an explanation. Many scholars have provided explanations, invoking, among other things, risk aversion of

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<sup>67</sup> See Bebchuk & Hamdani, *supra* note 63, at 553-57.

<sup>68</sup> My authority for this paragraph is my extensive practice experience and interviews with many other practitioners. See also John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame The Lawyers*, 89 CAL. L. REV. 1301, 1304-05 (2001) (arguing that adoption of particular takeover defenses is importantly determined by a particular firm's practices rather than the client's needs). Coates's article is in a different context than the one discussed in the text, and hypothesizes an "agency cost" in which the law firm's interests are being pursued at the expense of the client's, but Coates' argument and the one in this Essay are related. Law firms settle on a particular practice and do not revisit it; the mechanism by which this occurs is presumably that individual lawyers are discouraged from deviating. In the context of takeover defenses, there is a clear better alternative for the client. For incorporation, there is not. Perhaps there is a better alternative that could be found through research. Or perhaps one would arise if the norm to incorporate in Delaware became less sticky.

<sup>69</sup> See David Mayers & Clifford W. Smith, Jr., *On the Corporate Demand for Insurance*, 55 J. BUS. 281 (1982) (an early influential article posing the puzzle); Li-Ming Han, *Managerial Compensation and Corporate Demand for Insurance*, 63 J. RISK & INS. 381 (1996) (explaining corporate insurance purchases by reference to managerial risk aversion); see also Victor P. Goldberg, *The Devil Made Me Do It: The Corporate Purchase of Insurance*, 5 REV. OF LAW & ECON. 541 (2009), available at <http://www.bepress.com/rle/vol5/iss1/art22> (giving alternative explanations for corporate purchases of insurance).

<sup>70</sup> See Mayers & Smith, *supra* note 69 at 282.

corporate managers,<sup>71</sup> expertise by insurance companies,<sup>72</sup> or requirements of the company's transacting partners.<sup>73</sup> Another explanation may be the one offered here for the purchase of subprime securities and CEO selection process: that those in charge of making the decisions are looking more to justification than to the substance of the decision. This may involve an agency cost, or it may not. The manager may think that if an event occurs that would have triggered a payout and she has not obtained insurance for the company, that she will be fired or reprimanded. But the company's shareholders might also punish the company in such a case; the manager might then be serving her company well by obtaining the insurance.

## V. LAW AS PART OF THE PROBLEM

The foregoing has discussed a problem: when a decision-maker makes a decision intended more to shield her from negative consequences than to yield the best possible decision. Might law provide a solution? Law is, unfortunately, often part of the problem.

Law, especially corporate law, encourages process-based justification, even where the process at issue can be followed fairly mechanically.<sup>74</sup> Consider fiduciary duty law, especially the duty of care and the duty of good faith under the duty of loyalty. Directors and officers show that they met their duties by demonstrating that they hired the appropriate advisors, and had meetings which lasted a sufficient period of time and conducted enough debate and inquiry.<sup>75</sup> There may be a formula – a true safe harbor, or something close enough – to avoid liability. Using the court-approved process may not yield a worse decision, but it probably incurs unnecessary costs in arriving at the decision that probably would have been arrived at in any event.

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<sup>71</sup> See Han, *supra* note 69, at 281-82.

<sup>72</sup> See Goldberg, *supra* note 68, at 542-43.

<sup>73</sup> *Id.* at 541.

<sup>74</sup> See Claire Hill & Brett McDonnell, *Executive Compensation and the Optimal Penumbra of Delaware Corporation Law*, 4 VA. L. & BUS. REV. 333, 336 (2009) [hereinafter Hill & McDonnell, *Executive Compensation*] (characterizing the post-*Van Gorkom* process of approving mergers in Delaware as resulting in “full employment” for investment bankers and lawyers); Claire A. Hill & Brett H. McDonnell, *Stone v. Ritter and the Expanding Duty of Loyalty*, 76 FORDHAM L. REV. 1769, 1772 n.14 (2007).

<sup>75</sup> See Hill & McDonnell, *supra* note 73, at 1769-72; Hill & McDonnell, *Executive Compensation*, *supra* note 73, at 336.



The emphasis on process reflects that courts do not want to micromanage business. It also reflects a desire to give business people certainty – to specify ways of proceeding that insulate a decision and the decision-maker from further scrutiny.<sup>76</sup> This ethos echoes, and encourages, a mindset favoring justification by formula.<sup>77</sup>

The next Section argues that one important solution to the problem is to develop and promote norms against the use of justifications that are merely acceptable, but not “good.” These norms should encourage business actors to use their own judgment, even if they can not consult a formula or an established past or present practice. As discussed above, law has difficulty in preventing people from using safe harbors as refuges from doing their own inquiry. But perhaps law can do something to help the problem. It can allow for more personal liability for business decision-makers in some cases. It can marshal dicta to encourage better practices, and can outlaw common practices it finds unsatisfactory. I turn to these issues in the next Section.

## VI. SOLUTIONS

The foregoing described contexts in which decision-makers made decisions that the decision-makers had more reason to think were

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<sup>76</sup> See Hickman & Hill, *supra* note 7, at 1188.

<sup>77</sup> A recent paper pointing out the extent to which justification can distort behavior is Gideon Parchomovsky & Alex Stein, *The Distortionary Effect of Evidence on Primary Behavior*, 124 HARV. L. REV. (forthcoming 2011), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1568884](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1568884). The authors discuss how actors’ behavior can be distorted by their need to make the best evidentiary case to a court. Inefficiency may result since a person may, for instance, allow behavior that harms her to continue so she can demonstrate that it occurred. Parchomovsky and Stein’s paper shares with this Essay the idea that the need to get some desired treatment – avoiding professional censure or getting a recovery in a lawsuit – can distort behavior and potentially be costly to society. Parchomovsky and Stein’s paper has some important differences, though. First, in their scenario, the behavior that does not represent a distortion is known, at least as a matter of theory. This Essay’s analogue – the best decision from a substantive point of view – is not known. This is precisely why the problem arises. Second, demonstrations made to a court are governed by different forces than demonstrations or justifications to one’s peers. In both instances, law and norms are relevant. But, to overstate for expository ease, norms inform law to a court, whereas law informs norms to one’s peers.

justifiable than were substantively good. The decisions have varying social costs, some quite large and some smaller.

What kind of solutions might be possible? If we characterize the greater society as having an interest in more critically-minded and less formulaic decision-making, one approach might be to align the interests of decision-makers with those of the greater society. One way this might be achieved is to make decision-makers personally responsible for their decisions. This might be achieved in several different ways.

One is to make decision-makers personally liable for their decisions. The liability could arise from the decision's outcome or from the process used to reach the outcome. Richard Painter and I have argued for the former solution in a particular context: highly compensated bankers. These bankers made risky decisions that allowed their banks to fail or suffer significant losses. We argued that such bankers should be personally liable if their banks fail; we would allow them to retain a million dollars of their own wealth, but no more. Investment banking is a business that can impose, and has recently imposed, enormous social costs. We argue that investment banking is presently structured in a manner that rewards excessive risk-taking. Investment bankers had significant equity stakes in their banks, and were willing to risk those. We argue that they might not be willing to risk losing amounts they hold outside the firm that enable them to maintain their accustomed standard of living.<sup>78</sup>

Obvious objections exist to our proposal, mostly notably that it may not be politically feasible.<sup>79</sup> But this may change given public disgust at continuing high banker compensation.<sup>80</sup> Even if it does become feasible, though, it is only a partial solution for highly compensated people in a field that imposes social costs. Limited liability is a bedrock principle in business, and it is simply not realistic to advocate abandoning it wholesale. Thus, many decision-makers making decisions more because the decisions

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<sup>78</sup> Claire A. Hill & Richard Painter, *Berle's Vision Beyond Shareholder Interests: Why Investment Bankers Should Have (Some) Personal Liability*, 33 SEATTLE U. L. REV. 1173, 1173-74 (2010).

<sup>79</sup> Substantive objections include the following: a regulation imposed by the U.S. or a state would tempt bankers to work where the regulation did not apply; fewer people would want to be investment bankers; bankers would find ways to hide their assets; innovation would be stifled as bankers flocked to safety. *Id.* at 1196-99.

<sup>80</sup> See, e.g., Eric Dash, *Federal Report Faults Banks on Huge Bonuses*, N.Y. TIMES, July 22, 2010, at A1.

are justifiable than because they are substantively good could not feasibly be made guarantors for their decisions.

What about trying to increase oversight of process? If the oversight is to be done by courts, this does not seem like a promising solution. As argued in the previous Section, courts, especially those deciding matters of corporate law, are notoriously reluctant to micromanage process. Courts are sometimes willing to say directors did not think long enough; they are not generally willing to say they did not think hard enough.<sup>81</sup> But one related avenue might be promising: trying to encourage norms and best practices in favor of critical thinking and against mechanical and formula based decision-making methodologies. Corporate “law” nowadays very much includes extra-legal forces such as pressure imposed by major shareholders, through the proxy process as well as the media.<sup>82</sup> Such pressure could make it less “safe” for decision-makers to follow certain types of established practices. Law could also have a role: decisions could include dicta encouraging more critical-mindedness. Of course, critical-minded decision-making is no panacea. Formulaic decision-making methodologies may at least impose a lower bound on the quality of decision-making.<sup>83</sup> But it may be realistic to hope that the decisions at issue, mostly those made by individuals working in an institutional setting, would be constrained by those institutions, thus providing a lower bound.

Law can also play another role. It may not be good at dictating the specifics of good process, but it can be quite good at dictating the specifics of bad process. In that regard, it can have a more direct role in limiting “safe harbors.” It can, for instance, label a particular practice “unreasonable” as a matter of law. By itself, this may not be sufficient. Consider that in 1999, the Seventh Circuit characterized reliance on Standard and Poor’s rating as unreasonable.<sup>84</sup> Eleven years later, reliance continues unabated, notwithstanding Enron and the subprime crisis. But

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<sup>81</sup> See, e.g., *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 241-44 (Del. 2009).

<sup>82</sup> See generally Hill & McDonnell, *Executive Compensation*, *supra* note 73, at 357-64.

<sup>83</sup> See text accompanying note 31.

<sup>84</sup> See *Quinn v. McGraw-Hill*, 168 F.3d 331 (7th Cir. 1999), *quoted and discussed in* Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 56 (2004).

court attempts to specify bad process, making “safe harbors” less safe, is an approach with some potential.

A final approach to consider is that interested parties – perhaps, industry groups – might be willing to subsidize research on better decision-making methodologies. They might be motivated by their collective interest or perhaps by an interest in avoiding regulation. In cases where there is a public interest, government, too, can subsidize such research.

## VII. CONCLUSION

Decisions made under uncertainty may be made more with a view towards justification than with a view towards making the best substantive decision. Norms may arise as to justifications the decision-maker’s community will accept; the decision-maker will often be guided by these norms. The result may be inferior decisions that impose social costs, sometimes significant ones. This phenomenon matters for law and policy. Massive overinvestment in subprime securities is an important example.

The problem will not be easy to address. At first blush, law would not seem a good place to look. The problem involves people taking refuge in an accepted methodology or practice rather than fully using their critical faculties. Law notoriously judges actions by reference to accepted norms in the community; it also notoriously focuses on process rather than substance.

This Essay aims to draw attention to the breadth of the problem, showing its roots and manifestations in standard human motivations. The breadth of the problem has not been appreciated. Might better solutions be possible if the problem is viewed at a higher level of abstraction? This Essay aims to raise this possibility, and otherwise inspire new ways of looking at what may have seemed like diverse phenomena.



## CATALYSTS FOR CLARIFICATION: MODERN TWISTS ON THE INSURABLE INTEREST REQUIREMENT FOR LIFE INSURANCE

Robert S. Bloink\*

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*The long dormant insurable interest doctrine is being revisited as banks and other funds purchase life insurance policies in increasing numbers. Some industry commentators have raised objections, accusing Wall Street of perpetrating schemes that amount to impermissible gambling on the lives, and deaths, of others. In response, Wall Street financiers have insisted that they are committed to complying with state insurable interest statutes and that their efforts at building a secondary market for life insurance policies is expanding consumer options and eliminating the long-standing monopsony of the insurance companies. A workable compromise between the insurance industry and Wall Street positions that will modernize the insurable interest doctrine must simultaneously protect the free-assignability of life insurance policies and avoid a rekindling of the long-despised practice of gambling on lives. Development of such a proposal requires comprehensive examinations of the history of the insurable interest doctrine, the modern context within which it is being applied, and the primary proposals to modernize the doctrine that have been offered to date.*

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### I. AN INTRODUCTION TO THE CURRENT INSURABLE INTEREST DEBATE

The long dormant insurable interest doctrine is now being revisited as an outgrowth of the last decade's halcyon financial markets.<sup>1</sup> As banks

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<sup>1</sup> See generally Bryan D. Bolton & Michael P. Cunningham, *An Ancient Doctrine Confronts Modern Problems*, FOR THE DEFENSE (Sep. 2008); Robert B. Barnett, Jr. et al., *Amended Substitute House Bill 404: Ohio's Definition of "Insurable Interest" Unfortunately Remains Largely Uncodified*, 19 OHIO PROB. L.J. 4 (2008); James C. Magner, *Whose Life (Insurance) is it, anyway?*, STEVE LEIMBERG'S EST. PLAN. EMAIL NEWSL. (Oct. 30, 2007); Jacob Loshin, *Insurance Law's Hapless Busybody: A Case Against the Insurable Interest Requirement*, 117 YALE L.J. 474 (2007); Robert B. Barnett, Jr. & Jessica B. Kling, *The Insurable Interest Rule: Who Kicked the Slumbering Bear-and Did it Wake Him Up?*, 16

and other funds purchase life insurance policies in increasing numbers, insurance industry commentators have raised objections, accusing Wall Street of perpetrating schemes that amount to impermissible gambling on the lives, and deaths, of others. Describing Wall Street's foray into the mortality markets as "death pools" designed to profit on the arrival of the Grim Reaper, commentators have characterized this practice as violating the spirit, if not the letter, of state insurable interest laws.<sup>2</sup>

In objection to such characterizations, Wall Street financiers assure the industry that they are committed to complying with state insurable interest statutes. They further suggest that their efforts at building a secondary market for life insurance policies is expanding consumer options and eliminating the insurance companies' long-standing monopsony.<sup>3</sup> Just as the viatical markets were created in an effort to help AIDS patients deal with end-of-life expenses, they argue, a robust secondary market will increase the liquidity and value of consumers' unwanted insurance policies.<sup>4</sup>

The enormous demand created by Wall Street's desire to make the life insurance market yet another sub-asset class in the greater asset-backed securities paradigm has served as the germ seed of some expansive interpretations of the insurable interest requirements, thus prompting many of the industry commentators' complaints.<sup>5</sup>

As regulators and legislators attempt to refine the insurable interest doctrine, this article examines the pitfalls and possibilities presented by their efforts to improve upon the policy objectives underlying the insurable interest requirement. Specifically, this article examines the insurable

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OHIO PROB. L.J. 171 (2006); Peter Nash Swisher, *The Insurable Interest Requirement for Life Insurance: A Critical Reassessment*, 53 DRAKE L. REV. 477 (2005).

<sup>2</sup> See Jenny Anderson, *Wall Street Pursues Profit in Bundles of Life Insurance*, N.Y. TIMES, Sep. 5, 2009, <http://www.nytimes.com/2009/09/06/business/06insurance.html?emc=eta1>; <http://www.nytimes.com/2009/09/06/business/06insurance.html?emc=eta1>; M. Corey Goldman, *'Til Death Do us Part*, HFM WEEK, Jan. 18-24, 2007, at 23; Magner, *supra* note 1.

<sup>3</sup> See, e.g., Natalie Rosenfelt, *The Verdict on Monopsony*, 20 LOY. CONSUMER L. REV. 402, 404 (2008).

<sup>4</sup> Vishaal Bhuyan, *LIFE MARKETS: TRADING MORTALITY AND LONGEVITY RISK WITH LIFE SETTLEMENTS AND LINKED SECURITIES* 14 (John Wiley & Sons eds., 2009); Kelly J. Bozanic, *An Investment to Die for: From Life Insurance to Death Bonds, the Evolution and Legality of the Life Settlement Industry*, 113 PENN ST. L. REV. 229 (2008).

<sup>5</sup> See e.g. Bolton, *supra* note 1.

interest doctrine and its place in the mixture of separate but interrelated issues implicated by STOLI transactions, including: (1) material misrepresentations made on the policy application; (2) placement of the burden of establishing an insurable interest; and (3) the doctrine's wider interrelationship with the bundle of intangible property rights inherent in a modern life insurance contract. By means of a thorough examination of the insurable interest doctrine in the context of these related and intertwined issues, this discussion serves as a call for measured restraint as policy makers attempt to address market abuses with changes to the long-standing insurable interest doctrine.

Recent commentary decrying STOLI and similar practices has, in many cases, focused on violations of the insurable interest doctrine. Largely unaltered in British and American law over 230 years, the insurable interest doctrine is a natural candidate for upgrade in the morass of insurance regulations and common law doctrines implicated by STOLI. Destabilization of the doctrine will introduce uncertainty as to the value of many life insurance policies. If potential purchasers can no longer be certain of whether a policy will be valid or void for lack of an insurable interest, the resulting questions about the enforceability of the contract creates a potential shadow looming large over the foundation of consumer confidence in life insurance generally. Rather than impinging on the insured's property interest in a life insurance policy by introducing uncertainty into the insurable interest requirement, the tangle of socially undesirable activities inherent in most STOLI transactions must be unwound and individually scrutinized. Violations of the insurable interest requirement are an essential element of STOLI, but other elements of the transaction are equally offensive. For instance, if the insurer does adequate due diligence, asking questions sufficient to ferret out offending policies, parties conspiring to purchase a policy as part of a STOLI scheme must, by necessity, make misrepresentations on the policy application. These misrepresentations are ripe for STOLI enforcement, as they often void the contract and also may violate criminal law. Focusing solely on revising the insurable interest doctrine is too narrow an approach to deal with modern problems like STOLI. Wholesale revision of the insurable interest doctrine is unnecessary, when other less drastic tools for combating STOLI and other undesirable practices are available.

Viewed in its historical context, the insurable interest requirement emerges as a relevant, powerful tool to combat unsavory life-insurance practices. The continuing relevance of the insurable interest doctrine, and the importance of policing misrepresentations on life insurance policies, will be explored as follows: Section II maps the development of the



insurable interest doctrine, placing it, and the contemporary discussion surrounding it, into historical context. Section III examines the effect that lack of an insurable interest has on the validity of policy, drawing out one of the disincentives the doctrine presents to STOLI participants. Further exploring the bar the insurable interest requirement presents to those who would purchase a life insurance policy for an improper purpose, section IV probes the allocation of the economic and legal burdens of the insurable interest requirement between parties to the insurance contract. Section V examines the history of life insurance as personal property, encouraging circumspect deliberation for those who would restrict the transferability of life insurance contracts. Concluding the examination of the transferability of life insurance contracts, Section VI surveys the history of the secondary market for life insurance. Section VII moves the discussion to recent cases illustrating the modern problems taxing the flexibility of the insurable interest doctrine. In addition to enunciating the courts' use of the insurable interest requirement, that section also draws out the second facet of the courts' analysis of STOLI, the misrepresentations necessarily made on most applications for STOLI policies. Finally, section VIII discusses NAIC and NCOIL and their affect on the insurable interest requirement.

## II. HISTORY OF THE INSURABLE INTEREST REQUIREMENT

### A. DEFINITION OF THE INSURABLE INTEREST REQUIREMENT FOR LIFE INSURANCE

In general, anyone purchasing a life insurance policy must have an insurable interest in the life of the insured. The definition of "insurable interest" has changed very little from its inception in English life insurance law in 1774<sup>6</sup> to its present manifestation in US statutory and case law.<sup>7</sup>

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<sup>6</sup> See LIFE ASSURANCE ACT, 1774, 14 GEO. 3, c. 48, §§ 1-3 (Eng.). The Act, which is still in force, provides as follows:

1. From and after the passing of this Act no insurance shall be made by any person or persons, bodies politick or corporate, on the life or lives of any person, or persons, or on any other event or events whatsoever, wherein the person or persons for whose use, benefit, or on whose account such policy or policies shall be made, shall have no interest, or by way of gaming or wagering; and every assurance made contrary to the true intent and meaning hereof shall be null and void to all intents and purposes whatsoever.

In most versions of the insurable interest requirement, a person has an insurable interest in the life of an individual based on either (1) “love and affection” or (2) a substantial economic interest in the continued life of that individual.<sup>8</sup> Additionally, an insured generally has an unlimited insurable interest in his or her life.<sup>9</sup>

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2. And it shall not be lawful to make any policy or policies on the life or lives of any person or persons, or other event or events, without inserting in such policy or policies the person or persons name or names interested therein, or for whose use, benefit, or on whose account such policy is so made or underwrote.

3. And in all cases where the insured hath interest in such life or lives, event or events, no greater sum shall be recovered or received from the insurer or insurers than the amount of value of the interest of the insured in such life or lives, or other event or events.

<sup>7</sup> Compare ARIZ. REV. STAT. ANN. § 20-1104(c)(1)-(2) (2010)(defining “insurable interest” as “a substantial interest engendered by love and affection... or a lawful and substantial economic interest in having the life, health or bodily safety of the individual insured continue, as distinguished from an interest which would arise only by, or would be enhanced in value by, the death, disablement or injury of the individual insured.”) with *Warnock v. Davis*, 104 U.S. 775, 779 (1881) (stating that an insurable interest arises “from the relations of the party obtaining the insurance, either as creditor of or surety for the assured, or from the ties of blood or marriage to him, as will justify a reasonable expectation of advantage or benefit from the continuance of his life.”).

<sup>8</sup> See, e.g., ARIZ. REV. STAT. ANN. § 20-1104(c) (20092010); N.D. CENT. CODE § 26.1-29-09.1 (2010); ALA. CODE 1975 § 27-14-3(a) (SUPP. I 2009); GA. CODE ANN. § 33-24-3(a) (SUPP. I 2009); CAL. INS. CODE § 10110.1(a) (2005); ARK. CODE ANN. § 23-79-103 (c)(1) (2004); MISS. CODE ANN. § 83-5-251(3) (20091972); But see *Halford v. Kymer*, 10 B. & C. 724 (1830) (holding that a father does not have an insurable interest in the life of his son because, under the Life Assurance Act of 1774, a pecuniary interest is essential to find an insurable interest.) contra *Loomis v. Eagle Life & Health Ins. Co.*, 6 Gray 396 (Mass. 1856) (stating that, under Massachusetts law, a father has an insurable interest in the life of his son); see also *Barnes v. London, Edinburgh & Glasgow L. Ins. Co.*, 1 Q.B. 864 (1892).; *Ersine Hazard Dickson*, *Insurable Interest in Life*, III, 44 AM. L. REG. 161 (1896).

<sup>9</sup> See, e.g., GA. CODE ANN. § 33-24-3(b) (SUPP. I 2009); CAL. INS. CODE § 10110.1(b); (2005); *Equitable Life Ins. Co. v. Cummings*, 4 F.2d 794 (3d Cir. 1925); *Davis v. Gulf States Ins. Co.*, 151 So. 167, 168 (Miss. 1933); *Hill v. United Life Ins. Ass'n*, 25 A. 771 (Pa. 1893); *Gray v. Nash*, 259 S.W.3d 286 (Tex. App. 2008);).

The “love and affection” brand of insurable interest is typically manifest as a close familial relationship.<sup>10</sup> An economic interest in the continued life of the insured often exists as a creditor-debtor relationship<sup>11</sup>, but has also been found to exist between partners in a company with respect to its employees.<sup>12</sup>

The relationships encapsulated by both the “love and affection” and “economic interest” types of insurable interest are viewed as giving a policy-owner an interest in the insured’s life that exceeds the pecuniary benefit the beneficiary will reap from the policy on the insured’s death.<sup>13</sup>

Though the foregoing definition of “insurable interest” has remained relatively static since its inception, its effectiveness in the face of modern variations on life insurance is still the subject of substantial disagreement.<sup>14</sup> Of particular importance to understanding its application to novel, contemporary life insurance arrangements are the policy considerations motivating the insurable interest requirement.

#### B. POLICY CONSIDERATIONS MOTIVATING THE INSURABLE INTEREST REQUIREMENT

The insurable interest requirement is motivated by two primary policy considerations: (1) the immorality inherent in gambling on the life of another human being and (2) the moral hazard created when a beneficiary

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<sup>10</sup> See, e.g., CAL. INS. CODE § 10110.1(a) (2005); ARK. CODE ANN. § 23-79-103(c)(1)(A); (2004).

<sup>11</sup> See, e.g., *Crotty v. Union Mut. Life Ins. Co. of Maine*, 144 U.S. 621 (1892); *Connecticut Mut. Life Ins. Co. v. Luchs*, 108 U.S. 498 (1883); *Warnock v. Davis*, 104 U.S. at 775.

<sup>12</sup> See, e.g., *Connecticut Mut. Life Ins. Co.*, 108 U.S. at 505-06; *Wal-Mart Stores, Inc. v. AIG Life Ins. Co.*, 901 A.2d 106 (Del. 2006); *Prime Mortg. USA, Inc. v. Nichols*, 885 N.E.2d 628, 669-70 (Ind. Ct. App. 2008) (holding that a statute giving an employer an insurable interest in its employees applies whether the employer provides the policy to the employee or purchases a policy on its employee’s life.).

<sup>13</sup> See, e.g., *Waldman v. Maini*, 195 P.3d 850 (Nev. 2008).

<sup>14</sup> Compare *Loshin*, *supra* note 1 (arguing that elimination of the insurable interest requirement will free economic forces to police the insurance industry and the secondary markets and protect against the abuses the insurable interest requirement is intended to assuage) with *BOLTON & CUNNINGHAM*, *supra* note 1 (analyzing the traditional insurable interest requirement as applied to the modern phenomenon of stranger-originated life insurance).

has a motivation to bring about the death of an insured to accelerate a policy's payout.<sup>15</sup>

Gambling on lives was a relatively common practice in 18<sup>th</sup> century England, where the institution resembled modern day sports betting. While this wagering sometimes took place in social settings, the preferred method for wagering was the purchase of life insurance contracts, most often on the lives of public figures. The value of these speculative contracts floated depending on factors affecting the perceived life expectancy of an insured, like the turning of tide in war and the progress of capital trials. Though public condemnation of the practice in England lagged far behind the rest of Europe, by the late-18<sup>th</sup> century, public sentiment had turned. Gambling on lives came to be viewed as blunting human empathy and encouraging acts by beneficiaries that would hasten collection of a policy's death benefit.<sup>16</sup>

A notorious example often cited as illustrating the moral hazard inherent in a life insurance policy issued to one without an insurable interest in the insured's life<sup>17</sup> is the case of Thomas Griffiths Wainwright (1774-1847).<sup>18</sup> Wainwright was an author and dandy with extravagant tastes that led him to commit increasingly risky and horrific crimes to satisfy his appetites and the debts they accumulated. When forgery and the acceleration of an inheritance by his uncle's suspicious death were insufficient to sustain Wainwright's lavish lifestyle, he turned to life insurance as an "investment." Wainwright insured the life of his sister-in-law, though he did not have an insurable interest in her life, and soon increased the coverage on her life six-fold. She died of poisoning shortly thereafter. Wainwright never successfully collected the life insurance proceeds, and he as he spent the remainder of his years in jail on a charge of forgery.<sup>19</sup> Though not as romanticized as the Wainwright case, another often cited example of moral hazard is the Weldon case, where a woman

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<sup>15</sup> See *Grigsby v. Russell*, 222 U.S. 149 (1911); *Warnock v. Davis*, 104 U.S. at 778-79; *Trinity College v. Travelers' Ins. Co.*, 18 S.E. 175 (N.C. 1893); *Aetna Life Ins. Co. v. France*, 94 U.S. 561 (1876); *Connecticut Mutual Mut. Life Insurance Company Ins. Co. v. Schaefer*, 94 U.S. 457 (1876); *Aetna Life Ins. Co. v. France*, 94 U.S. 561 (1876); William Reynolds Vance, *HANDBOOK OF THE LAW OF LIFE INSURANCE* 125-26 (1904); Robert W. Buechner, *Stranger-Owned Life Insurance: The Good, the Bad, and the Ugly*, 19 OHIO PROB. L.J. 7 (2008).

<sup>16</sup> GEOFFREY WILSON CLARK, *BETTING ON LIVES: THE CULTURE OF LIFE INSURANCE IN ENGLAND, 1695-1775* 49-60 (1999).

<sup>17</sup> See, e.g., *Grigsby*, 222 U.S. at 154-155.

<sup>18</sup> Wainwright wrote under the pseudonym Janus Weathercock.

<sup>19</sup> ALEXANDER COLIN CAMPBELL, *INSURANCE AND CRIME* 223-38 (1902).

purchased a life insurance policy on the life of her two-and-one-half-year-old niece and then poisoned the child in an effort to accelerate payment of the policy's death benefit.<sup>20</sup>

It is worthwhile to note that in both the Wainwright and Weldon cases, at the time each crime occurred, both jurisdictions had an insurable interest requirement that voided the policies.<sup>21</sup> While these examples are proof that in at least some cases the insurable interest requirement is insufficient to eliminate the motivation of an individual with a criminal disposition to use life insurance as part of a nefarious scheme, the requirement is likely to have at least some deterrent effect by exponentially increasing the difficulty of securing a death benefit payout in the absence of an insurable interest.<sup>22</sup>

### C. SNAPSHOT OR CONTINUUM

#### 1. In general

Generally, an insurable interest is required only at the time a life insurance policy is issued, unless the policy specifies otherwise.<sup>23</sup> This stands in contrast to most other types of insurance policies, which require beneficial owners of a policy to have an insurable interest in the subject matter of the policy both when the policy is issued and when the policy pays on a loss.<sup>24</sup>

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<sup>20</sup> *Liberty National Life Insurance Co. v. Weldon*, 100 So.2d 696 (Ala. 1957).); *See also* *MutualMut. Life Ins. Co. v. Armstrong*, 117 U.S. 591 (1886) (considering whether the assignee of a life insurance policy is permitted to recover the policy's death benefit. Unsurprisingly, the Court decided against the murderer.); Ben Kingree & Louise Tanner, *Life Insurance as Motive for Murder*, 29 TORT & INS. L.J. 761 (1994).

<sup>21</sup> *See* LIFE ASSURANCE ACT, 1774, 14 Geo., 3, c. 48 (Eng.); *Liberty National Nat'l Life Insurance Ins. Co. v. Weldon*, 100 So.2d 696 at 704; Campbell, *supra* note 19, at 225;.

<sup>22</sup> *See* Kingree & Tanner, *supra* note 20, at 772.

<sup>23</sup> *See, e.g.,* MO. REV. STAT. § 5862; *Connecticut MutualMut. Life Insurance Company Ins. Co. v. Schaefer*, 94 U.S. 457, 461 (1876); *MutualWellhouse v. United Paper Co.*, 29 F.2d 886 (5<sup>th</sup> Cir. 1929); *Mut. Life Insurance Ins. Co. v. Allen*, 138 Mass. 24 (1884); *Olmsted v. Keyes*, 85 N.Y. 593 (1881); *Bowers v. Missouri Mut. Ass'n*, 62 S.W.2d 1058 (Mo., 1933); *First-Columbus Nat. Bank v. D. S. Pate Lumber Co.*, 141 So. 767 (Miss. 1932); *Appeal of Corson*, 6 A. 213 (Pa. 1886); *Hilliard v. Jacobs*, 874 N.E.2d 1060 (Ind. Ct. App. 2007); *Rawls v. American Life Ins. Co.*, 36 Barb. 357 (N.Y. Sup. Ct. 1862);

<sup>24</sup> *See generally* 44 C.J.S. *Insurance* § 322 (2009/2010).

From the advent of the insurable interest requirement, most jurisdictions have followed the modern rule, only requiring an insurable interest in the insured's life at the time the policy is issued and not at any time thereafter.<sup>25</sup> For example, when a life insurance policy purchased on a spouse's life during marriage names the other spouse as a beneficiary, in most jurisdictions, divorce will not terminate an ex-spouse's right to collect policy proceeds even though the ex-spouse's insurable interest likely died with the divorce.<sup>26</sup>

## 2. Application of the Insurable Interest Requirement to Policy Assignments

While the insurable interest requirement has generally only applied at a policy's issuance, courts have struggled with the issue of whether an insurable interest is also required of an assignee on assignment of the policy. While the present rule permitting assignment to a person without an insurable interest is fairly uniform across jurisdictions, prior to the 20<sup>th</sup> century, there was a split of authority. In some jurisdictions, an assignment of a life insurance policy to a person without an insurable interest in the insured's life was void as a matter of law.<sup>27</sup> In other jurisdictions, such an assignment was permissible, though not so to the extent it violated the prohibition on wager policies.<sup>28</sup>

Courts requiring an assignee to have an insurable interest in the life of the insured typically reasoned that the public policy rationale for

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<sup>25</sup> See, e.g., *Steinback v. Diepenbrock*, 158 N.Y. at 30 (1899); *Appeal of Corson*, 6 A. at 213.

<sup>26</sup> *Connecticut Mutual Mut. Life Ins. Co.*, 94 U.S. at 457; *Land v. West Coast Life Ins. Co.*, 270 P.2d 154, 156 (Or. 1954); *Begley v. Miller*, 137 Ill. App. 278 (1907).

<sup>27</sup> See, e.g., *Warnock v. Davis*, 104 U.S. 775, 781 (1881); *Stevens v. Warren*, 101 Mass. 564 (1869); *Franklin Life Ins. Co. v. Hazzard*, 41 Ind. 116, 121 (1872) (refusing to permit assignment of a policy to one without an insurable interest on the grounds that "[a]ll the objections that exist against the issuing of a policy to one upon the life of another in whose life the former has no insurable interest, seem to us to exist against his holding such policy by mere purchase and assignment from another. In either case, the holder of such policy is interested in the death, rather than the life, of the party assured.).").

<sup>28</sup> See e.g. *Steinback v. Diepenbrock*,<sup>28</sup> See, e.g., *Midland Nat'l Bank of Minneapolis v. Dakota Life Ins. Co.*, 277 U.S. 346 (1928); *Grigsby*, 222 U.S. 149 (1911); *Mut. Life Ins. Co. v. Armstrong*, 117 U.S. 591 (1886); *Aetna Life Ins Co v. France*, 94 U.S. 561, 563-64 (1876); *Steinback v. Diepenbrock*, 52 N.E. at 662.

requiring an insurable interest at a policy's inception apply equally on assignment of the policy. They reasoned that the assignee gambles that the insured will die sooner rather than later, thus benefitting from the insured's early passing. They also viewed the assignee as motivated to hasten the insured's death to the same extent as a person without an insurable interest who purchases a policy on the insured's life from an insurance company.<sup>29</sup>

In jurisdictions requiring assignees to have an insurable interest in the insured's life, an assignee who purchased a policy from the insured was treated as the insured's creditor to the extent of amounts expended by the assignee. The assignee was only permitted to recover an amount of the death benefit equal to the sum of consideration paid for the assignment and any premiums and fees paid by the assignee.<sup>30</sup>

By the early 20<sup>th</sup> century, a majority of jurisdictions generally upheld assignment of a life insurance policy to an assignee without insurable interest in the insured's life.<sup>31</sup> However, some assignments are still impermissible.

### 3. Prohibited Assignments

Schemes designed to circumvent the insurable interest requirement by effectuating an initial purchase of a life insurance policy by a person with an insurable interest in the insured's life and subsequently transferring the policy to a party without an insurable interest are not a new phenomenon.<sup>32</sup> In the late 19<sup>th</sup> century, jurisdictions requiring an insurable interest only at a policy's inception were aware that permitting assignment of life insurance policies made circumventing the insurable interest requirement possible but believed that other policy considerations outweighed the danger of permitting free-assignment (see *infra* section V).<sup>33</sup>

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<sup>29</sup> *Id.*

<sup>30</sup> See, e.g., *Culver v. Guyer*, 29 So. 779 (Ala. 1901); *Missouri Valley Life Ins. Co. v. Sturgis*, 18 Kan. 93 (1877);).

<sup>31</sup> *Steinback*, 52 N.E. at 663 (considering whether assignment of a policy to an assignee without an insurable interest in the insured's life was permissible, and concluding that: "The result of our further examination persuades us that what has been understood to be the rule in this state is not only in line with the authorities in most jurisdictions upon that subject, but is sound as a matter of public policy.") (emphasis added).

<sup>32</sup> *Warnock*, 104 US 775 (1881).

<sup>33</sup> *Steinback*, 158 N. Y. 24 at 31.

Even where an insurable interest appears to have existed at a policy's issuance, courts often dig deeper to determine whether the party with an insurable interest in the insured's life purchased the policy with the intent to circumvent the prohibition on wager policies.<sup>34</sup> The intent of the parties to a transaction involving the purchase and assignment of a policy controls treatment of the transactions. Regardless of the form of the transaction, if the intent of the parties is to effectuate a wager policy, courts ignored the intermediate step of the insured purchasing the policy and read the transaction as a direct purchase of the policy by the assignee. If the assignee did not have an insurable interest in the insured's life, the policy was void for lack of an insurable interest.<sup>35</sup>

The modern approach to assignments developed through two U.S. Supreme Court cases, *Warnock* and *Grigsby*.

#### 4. Warnock

*Warnock* was an early U.S. Supreme Court case holding that the assignment of a life insurance policy to someone without an insurable interest was impermissible. In *Warnock*, the insured purchased a life insurance policy and assigned the policy to investors who would pay all premiums on the policy, retaining nine-tenths of the policy's death benefit and remitting the remaining ten-percent to the insured's family.<sup>36</sup>

The Supreme Court held that an assignment of a policy to a person without an insurable interest in the insured's life was impermissible because it was just as objectionable as purchase of the policy outright by that same party. The assignee has, after all, a pecuniary interest in the insured's death.<sup>37</sup>

Rather than void the assignment, the Court permitted the assignee to recover an amount equal to the assignee's outlay in the transaction. The assignment, and the subsequent payout of the death benefit, was partitioned into two components. The first part was an amount equal to sums actually advanced by the assignee, with interest.<sup>38</sup> This amount was essentially

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<sup>34</sup> Conn. Mut. Life. Ins. Co. v Schaefer, 94 U.S. 457, 460-63 (1876); Loomis v. Eagle Life & Health Ins. Co., 6 Gray 396, 398-99 (Mass. 1856). *Steinback*, 158 N. Y. at 31; See generally Application of the insurable interest requirement to assignments is discussed *infra*.

<sup>35</sup> *Steinback*, 158 N. Y. 31-32.

<sup>36</sup> *Warnock*, 104 U.S. at 775-76; See also Franklin Life Insurance Company v. Hazzard, 41 Ind. 116, 117-18 (1872).

<sup>37</sup> See *Warnock*, 104 U.S. at 779-80.

<sup>38</sup> *Id.* at 781.



deemed to be a loan from the assignee to the insured. As such, the assignee has an insurable interest in the insured's life to the extent of this amount, and the assignment is valid to that extent. The second part of the assignment, which includes any amount of the payout in addition to the first amount, was a payout on an illegal wager policy.<sup>39</sup>

Cases decided subsequent to *Warnock* often focused on the fact that the policy at issue in *Warnock* was taken out under an agreement to immediately assign the policy; the policy was purchased to benefit parties without an insurable interest in the insured's life and was clearly a wager policy.<sup>40</sup>

### 5. Grigsby

The second case, *Grigsby*, took a more nuanced approach than *Warnock*, holding that assignments factually akin to those in *Warnock* were invalid, but that a blanket prohibition on assignment to a person without an insurable interest was too restrictive. While cases decided by the U.S. Supreme Court prior to *Warnock* had hinted at the free assignability of life insurance policies without an insurable interest requirement,<sup>41</sup> it was not until the Court's decision in *Grigsby* that the doctrine took its final, modern form.<sup>42</sup>

In *Grigsby*, the insured assigned a policy to someone without an insurable interest after the policy was purchased and after the insured made two premium payments. When the insured was unable to make the third

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<sup>39</sup> See *id.* at 782-83; *Cammack*, 82 U.S. 643, 647-48 (1872); See also *Steinback*, 158 N.Y. at 32-33.

<sup>40</sup> See *Steinback*, 158 N. Y. at 32. Without addressing *Warnock*'s arguments against assignability, the court in *Steinback v. Diepenbrock* (1899) held that assignment of a validly issued life insurance policy to a person without an insurable interest in the insured's life is permissible. In discussing *Warnock*, the court emphasized that the transaction at issue in *Warnock* would be illegal because it involved the purchase of a policy with the intent to sell it. They believed it unfair to restrict policy holders from selling their policies to attend to their financial needs, especially when the insured suffers from an illness that has dramatically reduced his or her lifespan.

<sup>41</sup> See *e.g.* *Aetna Life Ins. Co. v. Fr.*, 94 U.S. 561, 563-64 (1876) (holding that an assignment by the insured to a family member is presumed not to be made as "cover for a wager policy," regardless of the arrangement between the parties for payment of premiums.); See also *N. Y. Mut. Life Ins. Co. v. Armstrong*, 117 U.S. 591, 597 (1886) (holding that a validly issued policy is freely assignable.).

<sup>42</sup> *Grigsby v Russell*, 222 U.S. 149 (1911).

payment, he sold the policy to a Dr. Grigsby to pay for needed surgery. There was no allegation that the insured purchased the policy with the intent to assign it to a third party.

Agreeing with *Warnock*, the U.S. Court of Appeals held that Grigsby was only permitted to take the policy's death benefit to the extent of his advances, including the amount he paid for the policy and premium payments he made prior to the insured's death.<sup>43</sup>

The U.S. Supreme Court, however, overruled the appellate court and extended the permissibility of assignments of life insurance policies to assignees without an insurable interest in the insured's life, "where an honest contract is sold in good faith."<sup>44</sup>

The Court recognized that in early English cases, the primary purpose of the insurable interest requirement was to prohibit wager policies. Citing the permissibility of remainders after life estates, the Court made the case that the law does not inherently disfavor "pecuniary benefit accruing upon a death."<sup>45</sup> The Court recognized that after a policy is validly issued, the insured will have the best frame of reference for deciding whether to trust a potential assignee.<sup>46</sup>

### III. IMPACT OF THE INSURABLE INTEREST REQUIREMENT ON A POLICY'S ENFORCEABILITY

The insurable interest requirement is fundamental to the existence of a life insurance contract. Because of the important public policy considerations motivating the requirement, an insurance contract issued without an insurable interest is in most cases void and cannot be resurrected by agreement of the parties or because of inaction on the part of the insurer.<sup>47</sup> The taint infecting a policy issued without an insurable interest thus follows a policy from its issuance to the insured's death.

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<sup>43</sup> *Russell v. Grigsby*, 168 F. 577 (6<sup>th</sup> Cir. 1909).

<sup>44</sup> *Grigsby v. Russell*, 222 U.S. at 156.

<sup>45</sup> *Id.* at 155-56.

<sup>46</sup> *Id.* at 155.

<sup>47</sup> *See* *Beard v. Am. Agency Life Ins. Co.*, 550 A.2d 677, 686-88 (Md. 1988); *Woods v. Washington Fidelity Nat. Ins. Co.*, 113 S.W.2d 121 (Mo. Ct. App. 1938). *But see* *Van Zandt v. Morris*, 17 So. 2d 435, 436 (Miss. 1944); *Rogers v. Atlantic Life Ins. Co.*, 135 S.C. 89 133 S.E. 215, 218 (S.C. 1926). *See generally* 44 C.J.S. *Ins.* § 378 (2009); RESTATEMENT (SECOND) OF CONTRACTS § 7, cmt. a (2009) (stating that a "'void contract' is not a contract at all; it is the 'promise' or 'agreement' that is void of legal effect").

## A. VOID AND VOIDABLE LIFE INSURANCE CONTRACTS

A life insurance policy purchased by a person without an insurable interest in insured's life is void *ab initio*.<sup>48</sup> An agreement that is void *ab initio* is unenforceable by either party to the agreement, because either the law does not provide a remedy for breach of the agreement or does not "recognize a duty of performance."<sup>49</sup> Generally, contracts that are void *ab initio* are missing an element essential for contract formation or are so violative of the law or public policy that it would be improper to enforce them in the courts.<sup>50</sup>

Though often referred to as a "void contract," an agreement that is void *ab initio* is not a contract and is unenforceable from its inception.<sup>51</sup> As a result, in most jurisdictions an insurer cannot be required to pay the death benefit on a life insurance policy that is void *ab initio*.<sup>52</sup>

In contrast to a void contract, a voidable contract is enforceable, but the legal obligations created by the contract may be rescinded at the option of one (or, alternatively, all) of the parties to the contract.<sup>53</sup> For instance, a life insurance contract is voidable by the company who issued the policy based on material misrepresentations made by the applicant that the insurer relied on when issuing the policy; for instance, when the insured fails to disclose serious health problems material to the company's decision whether to issue the policy.<sup>54</sup>

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<sup>48</sup> See e.g. ARIZ. REV. STAT. ANN. § 20-1104 (2002); CAL INS. CODE § 10110(e) (1997); Warnock v. Davis, 104 U.S. 775, 779 (1881); Conn. Mut. Life Ins. Co. v. Schaefer, 94 U.S. 457, 460, 24 L.Ed. 251 (1876); First Penn-Pacific Life Ins. Co. v. Evans, 313 Fed.Appx. 633, 636 (4<sup>th</sup> Cir. 2009); Wuliger v. Mfrs. Life Ins. Co., 567 F.3d 787, 796-97 (6<sup>th</sup> Cir. 2009); Paul Revere Life Ins. Co. v. Fima, 105 F.3d 490, 492 (9<sup>th</sup> Cir. 1997); AXA Equitable Life Ins. Co. v. Infinity Financial Group, LLC, 608 F.Supp.2d 1349 (S.D.Fla. 2009); Ky. Cen. Life Ins. Co. v. McNabb, 825 F.Supp. 269, 272 (D. Kan. 1993); Gristy v. Hudgens, 203 P. 569, 572 (Ariz. 1922); Beard v. Am. Agency Life Ins. Co., 550 A.2d 677, 688 (Md. 1988).

<sup>49</sup> RESTATEMENT (SECOND) OF CONTRACTS § 7, cmt. a.

<sup>50</sup> See e.g., Bassett v. Nat'l Collegiate Athletic Ass'n, 528 F.3d 426 (6<sup>th</sup> Cir. 2008).

<sup>51</sup> RESTATEMENT (SECOND) OF CONTRACTS § 7, cmt a.

<sup>52</sup> See generally 44 C.J.S. Ins. § 352 (2009).

<sup>53</sup> BLACK'S LAW DICTIONARY *void contract* (8th Ed. 2004).

<sup>54</sup> 3 AM. JUR. PROOF OF FACTS 3d 367. See e.g. Gay v. United Benefit Life Ins. Co., 96 So.2d 497, 489-99 (La. 1957).

B. EXCEPTIONS TO THE NONENFORCEABILITY OF A POLICY  
ISSUED WITHOUT AN INSURABLE INTEREST

In a small minority of jurisdictions, including Texas, an insurer who issues a policy to a party without an insurable interest in the insured's life may nevertheless be required by the court to pay out policy proceeds. In such a case, the policy may be void or voidable with respect to the party purchasing the policy but can still be given effect by the court. When required to pay out on such a policy, the proceeds will generally be distributed under equitable principles. In most cases, this rule results in payment of policy proceeds to the decedent insured's estate.<sup>55</sup>

The justification for requiring a company to pay on an otherwise illegal policy is that the insurer should not be permitted to take shelter in failure of the insurable interest requirement when the insurer was in the best position to determine whether the requirement was satisfied. The insurer is not harmed by being required to pay the set amount it contracted to pay under the policy, even though the estate was not a named beneficiary.<sup>56</sup>

C. THE INSURABLE INTEREST REQUIREMENT AND CONTESTABILITY  
PERIOD

In a small minority of jurisdictions there are limited circumstances under which an insurance company will not be permitted to rescind a policy issued without an insurable interest. Most jurisdictions provide for a contestability period, after which a life insurance company is not permitted to challenge the policy's enforceability based on the applicant's fraud or misrepresentation. Most states have a two-year contestability period.<sup>57</sup>

Generally, an incontestability clause is based on the presumption that a valid contract exists. In the case of voidable contracts—such as those entered into based on misrepresentations by the applicant—a valid contract exists, and the contestability period applies to permit the insurance company to challenge payout on the policy.<sup>58</sup>

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<sup>55</sup> See e.g., *Steinback v. Diepenbroc*, 52 N.E. 662 (N.Y. 1899).

<sup>56</sup> *Tamez v. Certain Underwriters at Lloyd's, London, Int'l Accident Facilities Inc.*, 999 S.W.2d 12, 14-16 (Tex.Ct. App. 1998).

<sup>57</sup> See e.g., CAL. INS. CODE § 10113.5(a) (2005); COLO. REV. STAT. § 10-7-102(b) (2010); D.C. CODE § 31-4703 (3)(A)(i) (2005); FLA. STAT. § 627.455 (2005).

<sup>58</sup> Bryan D. Bolton & Michael P. Cunningham, *An Ancient Doctrine Confronts Modern Problems*, FOR THE DEFENSE 57, 61 (Sept. 2008).

Because a contract purchased by a party without an insurable interest in the insured's life is void, and not simply voidable, most states permit a life insurance company to challenge the enforceability of a life insurance contract on insurable interest grounds even after the close of the contestability period,<sup>59</sup> on the basis that to disallow a challenge to the legality of a contract purchased without an insurable interest would allow private parties to subvert public policy by agreement.<sup>60</sup>

Only two jurisdictions—Michigan and New York—have barred an insurance company from rescinding a policy issued without an insurable interest after the contestability period has passed.<sup>61</sup>

#### IV. BURDEN OF ESTABLISHING INSURABLE INTEREST

Though the duty to determine whether an insurable interest exists when a policy is issued rests at least nominally on the insurer's shoulders,<sup>62</sup>

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<sup>59</sup> See, e.g., *Paul Revere Life Ins. Co. v. Fima*, 105 F.3d 490 (9th. Cir. 1997); *Carter v. Cont'l Life Ins. Co.*, 115 F. 2d 947 (D.C. Cir. 1940); *Aetna Life Ins. Co. v. Hooker*, 62 F.2d 805 (6<sup>th</sup> Cir. 1933) *First Penn Pacific Life Ins. Co. v. Evans*, No. 05-444, 2007 WL 1810707 (D.Md. 2007); *Ky. Cent. v. McNabb*, 825 F. Supp. 269 (D.C. Kan. 1969); *Commonwealth Life Ins. Co. v. George*, 28 So.2d 910 (Ala. 1947); *Home Life v. Masterson*, 21 S.W.2d 414 (Ark. 1929); *Foreman v. Great United Mut. Benefit Ass'n*, 23 N.E. 2d 813 (Ill. App. Ct. 1939); *Bromley's Adm'r v. Wash. Life Ins. Co.*, 92 S.W. 17 (Ky. 1906); *Stevens v. Woodmen of the World*, 71 P.2d 898 (Mont. 1937); *Wharton v. Home Sec. Life Ins. Co.*, 173 S.E. 338 (N.C. 1934); *Brady v Prudential Life Ins. Co.*, 5 Kulp 505 (1890); *Henderson v. Life Ins. Co. of Va.*, 179 S.E. 680 (S.C. 1935). See generally Franklin L. Best Jr., *Securitization of Life Insurance Policies*, 44 TORT TRIAL & INS. PRAC. L.J. 911 (2009).

<sup>60</sup> Additionally, most jurisdictions will not allow the use of waiver and estoppel to force a life insurance company to pay out on a policy issued without an insurable interest or bar an insurer from raising lack of an insurable interest as a defense to payment of policy proceeds. See *Kentucky Cent. Life Ins. Co. v. McNabb*, 825 F.Supp. 269 (D.Kan. 1993); *Beard v. American Agency Life Ins. Co.*, 550 A.2d 677 (Md. 1988); *Woods v. Washington Fidelity Nat. Ins. Co.*, 113 S.W.2d 121 (Mo. Ct. App. 1938). See generally C.J.S. *Ins.* § 378 (2007).

<sup>61</sup> See e.g. *Bogacki v. Great-West Life Assur. Co.*, 253 Mich. 253 (Mi. 1931); *New England Mut. Life Ins. Co. v. Caruso*, 523 N.Y.S.2d 928 (N.Y. App. Div. 1988), order *aff'd*, 73 N.Y.2d 74 (1989). Note that in Michigan, the decision to bar rescission of a contract issued without an insurable interest was based on the fact that the state did not have an insurable interest statute. The public policy considerations driving the contestability statute were held to prevail over the common law insurable interest requirement. *Bogacki*, 234 N.W. at 866.

in effect, the financial burden resulting from failure of the insurable interest requirement falls decisively on the policy's owner and beneficiaries.<sup>63</sup> As established above, a policy issued in violation of the insurable interest requirement is generally void and unenforceable and, regardless of any inequity, the insurer will not be required to pay out on the policy to the policy's beneficiaries, the decedent's family members, or any other party.<sup>64</sup> The purchaser of the policy issued without an insurable interest will, in most cases, hold a valueless policy, and beneficiaries will not receive the policy's death benefit if the policy is found to have been issued without an insurable interest. Thus, for practical purposes, it is a policy's owner and beneficiaries who bear the economic burden of the insurable interest requirement.

In addition to bearing the financial burden associated with a failure of the insurable interest requirement, beneficiaries also have the burden of proving the existence of an insurable interest in a lawsuit on a life insurance policy.<sup>65</sup> The burden is the beneficiary's regardless of whether the beneficiary brings suit to compel the insurance company to pay the death benefit to the beneficiary, or if the insurer seeks a declaratory judgment stating that the beneficiary has no right to the policy proceeds.<sup>66</sup>

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<sup>62</sup> An insurer who does not conduct due diligence when issuing or paying out on a policy may inadvertently pay on a void policy or face the expense of challenging a beneficiary's right to a policy payout. In general, only the insurer has the power to raise lack of an insurable interest as a defense to payment on a policy. *See e.g.*, *National Life Ins. Co. v. Tower*, 251 F.Supp. 215 (D. Md. 1966); *In re Marriage of Day*, 74 P.3d 46 (Kan. Ct. App. 2003); *Ryan v. Tickle*, 316 N.W.2d 580 (Neb.1982); *Moran v. Moran*, 346 N.Y.S.2d 424 (N.Y. Sup. Ct. 1973).

<sup>63</sup> Beneficiaries have the burden of proving the existence of an insurable interest. *See Kentucky Cent. Life Ins. Co. v. McNabb*, 825 F.Supp. 269 (D. Kan. 1993); *Rubenstein v. Mutual Life Ins. Co. of New York*, 584 F.Supp. 272 (D.C. La. 1984); *American Nat. Ins. Co. v. Moore*, 70 So. 190 (Ala. Ct. App. 1915); *Interstate Life & Acc. Co. v. Houseworth*, 25 S.E.2d 233 (Ga. Ct. App. 1943). The burden is the beneficiary's regardless of whether the beneficiary brings suit to compel the insurance company to pay the death benefit to the beneficiary, or if the insurer seeks a declaratory judgment stating that the beneficiary has no right to the policy proceeds. *See e.g.*, *Kentucky Cent. Life Ins. Co.* 825 F.Supp. at 273.

<sup>64</sup> *See supra* Part III.

<sup>65</sup> *Kentucky Cent. Life Ins. Co.* 825 F.Supp. at 269; *Rubenstein v. Mutual Life Ins. Co. of New York*, 584 F.Supp. 272 (D. La.,1984); *American Nat. Ins. Co. v. Moore*, 70 So. 190 (Ala. Ct. App. 1915); *Interstate Life & Acc. Co.*, 25 S.E.2d at 233.

<sup>66</sup> *See e.g.* *Kentucky Cent. Life Ins. Co. v. McNabb*, 825 F.Supp. at 269. Insurers have also been held liable for failing to inform the insured that a policy

Up to this point, the discussion has been limited to claims sounding in contract. Though an insurer who carelessly or even intentionally issues a policy to a party without an insurable interest in the insured's life cannot usually be compelled to pay the policy's death benefit, an insurer may be held liable in tort for the failure. Insurers have a duty to use reasonable care in determining whether the purchaser of a policy has an insurable interest in the insured's life, and can be held liable in a wrongful death suit for failing to investigate whether the party purchasing the policy has an insurable interest, where the insured is murdered so the policy owner can collect on the policy.<sup>67</sup>

Regardless of who bears the burden—financial or otherwise—of determining whether an insurable interest exists at policy issuance ultimately falls upon, in practice, such determination is best made at policy issuance based on responses to the policy application. The questions and representations requested within a policy application are not static, and the insurance carrier has wide latitude to alter these questions to ascertain issues pertaining to the existence of a valid insurable interest. As a result, the carrier's application can serve as a first line of defense against undesirable life insurance practices like STOLI. The insurance carriers bear some portion of the burden to fortify their policy applications to discover whether an insurable interest exists, and ferret out potential abuses, prior to policy issuance. The applicant's contemporaneous burden to be truthful, and not make material misrepresentations on an well crafted insurance application will serve to ensure the presence of a bona fide insurable interest as a life insurance policy is issued.

## V. THE DEVELOPMENT OF LIFE INSURANCE AS PERSONAL PROPERTY

### A. INTRODUCTION

Life insurance contracts developed from a simple, nontransferable contract providing security for the insured's family into its modern form,

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has been taken out on his life. *Ramey v. Carolina Life Ins. Co.*, 135 S.E.2d 362 (S.C. 1964).

<sup>67</sup> *Overstreet v. Ky. Cent. Life Ins. Co.*, 950 F.2d 931 (4th Cir. 1991); *Liberty Nat. Life Ins. Co. v. Weldon*, 100 So.2d 696 (Ala. 1958); *Life Ins. Co. of Georgia v. Lopez*, 443 So.2d 947 (Fla. 1983); *Bajwa v. Metropolitan Life Ins. Co.*, 804 N.E.2d 519, 533-35 (Ill., 2004).

which includes an investment or savings component.<sup>68</sup> Life insurance contracts are a type of personal property called a “chose in action.”<sup>69</sup> A chose in action gives the person holding the chose “the liberty of proceeding in the courts of law.” The holder has a right to pursue an action in damages or to compel the payment of money due.

Historically, English law did not recognize the existence of intangible personal property. As such, the chose in action was a nontransferable right that could be exercised only by its original holder.<sup>70</sup> An attempted assignment of a chose in action gave no rights to the assignor.<sup>71</sup> But the commercial desirability of permitting the assignability of contract rights and the right to sue on those rights eventually prompted innovation allowing transferability of the chose in action.

Initially, an assignment could only be made indirectly, with the assignee pursuing a cause of action in the assignor’s name.<sup>72</sup> Modern law dispenses with this requirement, allowing the assignor to bring suit in his own name.<sup>73</sup>

#### B. HISTORICAL DEVELOPMENT OF LIFE INSURANCE CONTRACTS AS TRANSFERABLE PERSONAL PROPERTY

Life insurance is a particular form of property subject to a set of rules crafted in response to its unique nature. Until the early 1900s, these

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<sup>68</sup> See Comment, *The Assignment of Life Insurance as Collateral Security for Bank Loans*, 58 YALE L.J. 743, 743-44 (1949).

<sup>69</sup> See *Central Nat. Bank v. Hume*, 128 U.S. 195, 207-208 (1888); *Warnock v. Davis*, 104 U.S. 775, 781-82 (1881); *Russell v. Grigsby*, 168 F. 577 (6th Cir. 1909). The phrase “chose in action” is a Norman French meaning, essentially, “right in action.” The chose in action stands in contrast to the “chose in possession,” which refers to a right of possession in movable personal property. Joseph James Darlington & Joshua Williams, *A TREATISE ON THE LAW OF PERSONAL PROPERTY* 6-11 (T. J.W. Johnson 1891).

<sup>70</sup> 1 SAMUEL WILLISTON, *THE LAW OF CONTRACTS* § 405 (Baker, Voorhis & Co. 1924). The advent of the transferability of the chose in action was stalled by the fear that transferability would encourage the offense of maintenance, the encouragement of a lawsuit by an uninterested party, here the transferee. See Darlington, *supra* note 69 at 7-9.

<sup>71</sup> See Darlington & Williams, *supra* note 69 at 6-7.

<sup>72</sup> *Id.* at 8-10.

<sup>73</sup> *Id.* at 10-11.



peculiarities stalled the development of life insurance as an investment and savings vehicle.<sup>74</sup>

One of the primary factors that limited or eliminated the investment value of pre-20<sup>th</sup> century life insurance contracts was their limited transferability. Although technically transferrable or assignable as security for a debt, under American law it was the beneficiary and not the insured or purchaser of the policy who had the power to assign the policy.<sup>75</sup>

Generally, 19<sup>th</sup> century life insurance policies were strictly a contract providing for a payout to beneficiaries on insured's death. Life insurance afforded protection to the insured's family should he meet an untimely end.<sup>76</sup> These policies did not generally allow the insured to change the policy's beneficiary.<sup>77</sup>

Policy beneficiaries were deemed to have an irrevocable vested interest in the policy, which protected the beneficiary's interest in the policy from the insured's creditors.<sup>78</sup> While the insured was under no obligation to continue making premium payment, the beneficiary was permitted to keep his or her vested interest in policy proceeds alive by making the premium payments.<sup>79</sup>

Nineteenth-century insurance contracts, as indicated, did not usually provide the insured with an option to change policy beneficiaries;<sup>80</sup> this was true even where the insured kept the policy in his physical possession and paid all premiums on the policy.<sup>81</sup> And because policies did not typically provide for any payout other than a death benefit, an insured did not have any power over the policy.<sup>82</sup> The insured's only role was to purchase the policy and pay the premiums. After the policy was issued, the

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<sup>74</sup> See generally Comment, *supra* note 68 at 743-44.

<sup>75</sup> See *id.* at 746.

<sup>76</sup> Charles Kelley Knight, HISTORY OF LIFE INSURANCE IN THE UNITED STATES TO 1870, 132-160 (1920) (unpublished Ph.D. dissertation, University of Pennsylvania) available at <http://books.google.com> (describing the development of life insurance from 1861-1870, a time of innovation that would permanently alter the purpose of life insurance).

<sup>77</sup> See Comment, *supra* note 68, at 746; *Douglass v. Equitable Life Assurance Soc.*, 90 So. 834, 835-36 (1922). See also Vance, *supra* note 15, at 407.

<sup>78</sup> *Yore v. Booth*, 42 P. 808, 808 (Cal. 1895).

<sup>79</sup> See Vance, *supra* note 15 at 201 (noting that payment of premiums by one who does not have an interest in the life insurance policy does not confer an ownership interest in payor.)

<sup>80</sup> See Comment, *supra* note 68, at 46-48.

<sup>81</sup> See *Yore*, 42 P. at 808. See generally Comment, *supra* note 68, 743-44, n.9.

<sup>82</sup> See Comment, *supra* note 68, at 745.

insured had no further say in the disposition of the policy, other than to cut off premium payments. As a result, an assignment of the policy was only valid if the beneficiary was a party to the assignment.<sup>83</sup> Because the insured had no control over a policy once it was issued, the insured did not have an interest in the policy that was capable of assignment. Beneficiaries, on the other hand, had a vested interest in policy proceeds that was capable of transfer or assignment to a third party.

When a life insurance policy did not reserve the insured's right to change the beneficiary, under the vested interest rule, the policy's beneficiaries had a vested interest in the life insurance policy. A beneficiary's vested interest could not be defeated by action of the insured, except to the extent permitted by the policy.<sup>84</sup> In contrast, when a policy reserved the insured's right to change the policy's beneficiary, the insured had only an expectancy in policy proceeds.<sup>85</sup>

In the late 19<sup>th</sup> century, insurers began to include provisions in their policies granting the insured the right to change the policy beneficiary.<sup>86</sup> This change was made, in part, as a response to the fact that, in most cases, the vested interest rule defeated the intent of the insured who purchased life insurance. Most insureds purchased policies to protect family members in the event of the insured's death. But the identity of dependent family members and their favor with the insured was likely to change during the insured's lifetime. An insured's ex-spouse, for instance, was a permanent beneficiary of the policy regardless of the insured's wishes or whether the ex-spouse continued to rely on the insured for support.<sup>87</sup>

In addition to permitting insureds to change policy beneficiaries during the life of the policy, life insurance companies also conceived of innovations like legal reserve life insurance, which introduced the concept of policy surrender value and produced new forms of insurance like whole life and universal life insurance.<sup>88</sup> These changes transformed life insurance

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<sup>83</sup> *Id.* at 747.

<sup>84</sup> *Filley v. Ill. Life Ins. Co.*, 93 Kan. 193 (Kan. 1914); *Van Bibber's Adm'r, & Co. v. Van Bibber*, 82 Ky. 347, 350 (Ky. 1884).

<sup>85</sup> See Comment, *supra* note 68, at 48-50.

<sup>86</sup> See *N. Y. Life Ins. Co. v. Daley*, 143 P. 1033 (Cal. Ct. App. 1914); *Douglass v. Equitable Life Assurance Soc'y.*, 90 So. 834, 835-36 (La. 1922).

<sup>87</sup> *Conn. Mut. Life Ins. Co. v. Schaefer*, 94 U.S. 457, 459-63 (1876); *Begley v. Miller*, 137 Ill.App. 278 (1907) *Land v. West Coast Life Ins. Co.*, 270 P.2d 154, 156-57 (Or. 1954).

<sup>88</sup> See *Vance*, *supra* note 68 at 344. Whole life insurance has a level premium for the life of the insured and accumulates value, permitting the insured to borrow against the policy during his or her lifetime. Like whole life insurance, universal

from a contract only providing for payment of a death benefit to a full-featured savings vehicle. With the steady development of rules and industry norms that transformed life insurance from simple insurance to an investment and savings product, life insurance was soon touted as an alternative to other investment products and bank savings accounts.<sup>89</sup>

Once these new contracts that permitted the insured to change beneficiaries made their way to the courts, the issue arose as to whether the insured must replace the beneficiary with the assignee in order to transfer the beneficiary's rights in the contract to the assignee. Most courts quickly realized that to withhold the assignee's rights in the contract where the beneficiary of the contract was not changed to reflect the assignment was to ignore the reality of the situation. The insured's right to change beneficiaries of a policy came to be viewed as an election by the insured to keep beneficial ownership for himself during his lifetime.<sup>90</sup> An insured with the power to change the policy beneficiary has the power to assign the policy, thus effectively cutting off any interest the original beneficiary had in the policy. Many courts viewed assignment of a policy as, in effect, an exercise of the insured's power to change the policy's beneficiary.<sup>91</sup>

### C. MODERN APPROACH TO ASSIGNMENT

Today, most states permit the assignment of a life insurance policy as long as the assignment is not entered into as cover for a wager policy.<sup>92</sup> A validly issued life insurance policy, purchased by the insured, is absolutely assignable, whether as collateral for a loan or in an absolute sale, without restriction. As such, a validly issued policy may be assigned to a person without an insurable interest in the insured's life.<sup>93</sup>

In spite of the assignability of life insurance policies, a minority of jurisdictions limit the amount of a policy's death benefit that is payable to a

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life insurance also accumulate internal value. In contrast to a whole life policy, a portion of each universal life policy premium is allocated to cost of insurance, with the remainder being allocated to policy buildup. BLACK'S LAW DICTIONARY 805 (6th ed. 1990).

<sup>89</sup> See Comment, *supra* note 68, at 344.

<sup>90</sup> See *id.* at 749.

<sup>91</sup> *Rawls v. Am. Life Ins. Co.*, 36 Barb. 357 (N.Y. Gen. Term. 1862); See Comment, *supra* note 68, at 49 n. 46.

<sup>92</sup> See *supra* Part II.

<sup>93</sup> See e.g., *Russell v. Grigsby*, 168 F. 577 (6th Cir. 1909); *Corning Bank & Trust. Co. v. Foster*, 74 S.W.2d 797 (Ark. 1934); *Lanier v. Shuman*, 24 S.E.2d 55 (Ga. 1943). See generally 30 A.L.R. 2d 1310 § 16 (2009).

creditor of the insured. Because a life insurance policy is often irreplaceable, such as when the insured is elderly or in poor health,<sup>94</sup> many jurisdictions restrict the extent to which a creditor is permitted to collect the policy's death benefit. When a policy is assigned to a creditor as security for a debt, the creditor's interest in the policy's proceeds cannot exceed the debt owed by the insured to the creditor. But full-assignment or sale of a policy does not result in a mere creditor's interest in policy proceeds. The assignee is entitled to full payment of the policy's death benefit.<sup>95</sup>

## VI. THE DEVELOPMENT OF THE SECONDARY LIFE INSURANCE MARKET

### A. GENESIS OF VIATICAL AND LIFE SETTLEMENTS

Life insurance developed from an unassignable right to payment of a death benefit into its present form as a full-featured savings vehicle. For most of its history, life insurance was intended primarily to provide security for the insured's family after the insured's death. Recent developments, however, are "turning life insurance on its head."<sup>96</sup> With \$26 trillion in life insurance policies in force in the US, it was only a matter of time before investors sought out ways to tap into this uncorrelated asset class.<sup>97</sup>

Prior to the 1980s, the business of buying and selling life insurance policies was not a robust industry. While life insurance policies were regularly bought and sold, the transactions did not take place in a developed market but occurred in relative isolation. The AIDS crisis of the 1980s and 90s, however, generated substantial interest in the purchase and sale of life insurance policies. With limited treatment options, individuals diagnosed with AIDS had radically reduced life spans, dramatically increasing the value of their life insurance policies. Viatical settlement companies sprang up, willing to purchase policies from the terminally ill insured for prices far in excess of the policy's surrender values, but at a price low enough to net the company a profit when the insured died. When

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<sup>94</sup> See Comment, *supra* note 68, at 745.

<sup>95</sup> See *St. John v. Am. Mut. Life. Ins. Co.*, 13 N.Y. 31 (N.Y. 1855).

<sup>96</sup> See Robert S. Bloink, *Premium Financed Surprises: Cancellation of Indebtedness Income and Financed Life Insurance*, 63 THE TAX LAWYER 283, 286 (2010).

<sup>97</sup> See Anderson, *supra* note 2. The value of a life insurance policy is uncorrelated to the performance of other markets, so life insurance offers a measure of perceived stability in the current tumultuous financial environment.

antiretroviral drugs began to extend the life expectancy of people infected with HIV, viatical settlements quickly expanded to include terminal illnesses other than AIDS.<sup>98</sup>

## B. THE SECONDARY MARKET FOR LIFE INSURANCE

Sensing the nearly endless supply of life insurance policies sitting idle in the hands of insureds and their families, the viatical settlement industry rapidly expanded into the life settlement market, offering elderly insureds who are not terminally ill the option of selling their life insurance policies for cash in excess of the surrender value of the policy.

The life settlement industry provides a steady stream of new policies for the secondary market, but demand for investor-owned life insurance policies far exceeds supply. This mismatch generated a demand for policies not purchased through life settlement channels. Banks, hedge funds and private equity groups saw the viatical markets and its permutations as a door into the profitable longevity of risk markets that had largely been the exclusive domain of insurance carriers for centuries.<sup>99</sup>

Wall Street imposed an asset backed securities<sup>100</sup> paradigm upon secondary life settlements and viatical markets with the hope the market would grow and develop as the mortgage market had developed 20 years

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<sup>98</sup> See generally *Life Partners, Inc. v. Morrison*, 484 F.3d 284 (4th Cir. 2007); Bloink, *supra* note 96; Alexander D. Eremia, *Viatical Settlement and Accelerated Death Benefit Law: Helping Terminal, but not Chronically Ill Patients*, 1 DEPAUL J. HEALTH CARE L. 773 (1997).

<sup>99</sup> See Anderson, *supra* note 2. Life settlement and viatical settlement involve the sale of a life insurance policy to a third party for less than the face value of the policy and prior to its maturity. The settlement amount is generally greater than the total amount of premiums and fees paid by the insured. In both types of settlement the purchaser will receive payment of death benefits on the policy. Life settlement is the sale of a life insurance policy on the life of a party who is not “terminally or chronically ill.” In viatical settlement, the insured is usually “terminally or chronically ill,” resulting in a shorter life expectancy than predicted by mortality tables. BLACK’S LAW DICTIONARY 1497 (9th ed. 2009). See generally Patrick D. Dolan, *Securitization of Life Settlements, Structured Settlements, and Lottery Awards*, NEW DEVELOPMENTS IN SECURITIZATION 2008 (Practicing Law Institute, Commercial Law and Practice Course Handbook Series, PLI Order No. 14108, 2008).

<sup>100</sup> Asset backed securities are securities that are secured by pooled, generally illiquid, assets such as mortgages, life insurance policies, or student loans. BLACK’S LAW DICTIONARY 1476 (9th ed. 2009).

earlier.<sup>101</sup> The investment calculus turned on mitigating the actuarial risk by aggregating large pools of insurance policies and an endless supply of cheap money to fund the ongoing premium obligations. Obtaining these large portfolios of insurance policies containing the right mix of premium costs and insureds' predicted mortality became an increasing problem.<sup>102</sup>

To generate a pool of policies significant enough to satisfy demand and to smooth the actuarial risk inherent in smaller pools, the market developed strategies designed to cut the insured out of the process. For investors, the ideal would be to directly purchase life insurance policies without the insured's involvement; however, the insurable interest requirement necessitated the crafting of complex strategies designed to utilize an insured's unlimited insurable interest in his own life to purchase policies that could not be issued directly to the investor. Stranger-owned life insurance is one of those strategies.

## VII. STRANGER-OWNED LIFE INSURANCE (STOLI)

### A. INTRODUCTION

Stranger-owned life insurance (STOLI) refers to the practice of purchasing a life insurance policy with the intent to transfer the policy to a third party.<sup>103</sup> STOLI takes many forms, but in general, it is an arrangement designed to acquire and transfer a life insurance policy to investors.<sup>104</sup>

Typically, a STOLI arrangement is initiated by someone other than the insured, such as an insurance broker, attorney, or other third party who approaches the insured and initiates the insured's involvement in the program. Though stranger or investor initiation of the purchase of the policy is typical it is not universal.<sup>105</sup>

Investors and third parties secure the participation of insureds with incentives and promises of profits when the policy is sold. Incentives may include a lump-sum payment at the policy's purchase, partial payment of

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<sup>101</sup> See Anderson, *supra* note 2; Rachel Emma Silverman, *Letting an Investor Bet on When You'll Die: New Insurance Deals Aimed At Wealthy Raise Concerns; Surviving a Two-Year Window*, WALL ST. J., May 26, 2005, at D1.

<sup>102</sup> See Bloink, *supra* note 96.

<sup>103</sup> See Best, *supra* note 59, at 912-13.

<sup>104</sup> See Stephan R. Leimberg, *Stranger Originated Life Insurance (STOLI): What Counsel (and What Every Advisor) Must Absolutely Positively Know!*, SP037 ALI-ABA 573 (2009).

<sup>105</sup> See *id.*

policy proceeds to the insured's family, or "free" insurance for the duration of the contestability period.<sup>106</sup>

STOLI arrangements often delay transfer of ownership of the life insurance policy or ILIT from the insured to investors until after the policy's incontestability period has passed, believing that the incontestability clause will shield the STOLI policy from challenge by the insurer.<sup>107</sup>

Insureds will generally be unwilling or unable to pay the premiums and other fees necessary to keep a high-value policy in force until the policy's incontestability period has passed. While investors may directly pay fees and premiums, premium financing—the use of borrowed funds to finance life insurance premiums—is the preferred method for making premium payments on a STOLI policy. In a premium financing arrangement, the premium finance lender—which may be a company specializing in such lending, a traditional lending institution like a bank, or even an insurance company—pays policy premiums on behalf of the borrower-insured. The cost of the loan, including interest and fees, may be billed to the insured or rolled into the loan.<sup>108</sup>

At the close of the premium finance loan period—which may range from a year to policy maturity—the insured must either: (1) repay the loan, including interest and fees, (2) roll the premium finance loan into a new loan, or (3) surrender the policy (and any additional collateral supplied by the borrower) to the premium finance lender.<sup>109</sup>

Premium finance makes it unnecessary for investors to directly pay premiums and fees to the insurance company, which may alert the company that the policy is part of a STOLI arrangement and trigger an investigation that could end in rescission of the policy. Premium finance also facilitates separation between investors and the insured by providing putative cover for the true nature of the arrangement.<sup>110</sup>

In traditional premium finance, the insured debtor generally intends on holding the insurance policy until its maturity. Traditional premium finance facilitates estate liquidity for wealthy insureds. Typically the

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<sup>106</sup> See *id.* An incontestability clause specifies a time limit on the insurer's right to revoke a policy based on the insured's misrepresentations. All jurisdictions require life insurance contracts to include an incontestability clause, most requiring an incontestability period no longer than two years from the date the policy is issued. *Id.*

<sup>107</sup> See *id.*

<sup>108</sup> See Bloink, *supra* note 96, at 284.

<sup>109</sup> See *id.* at 284-85.

<sup>110</sup> See *Id.* at 287.

premium finance loan is secured by the insurance policy and is fully recourse as to the insured. In contrast, when used in a STOLI arrangement, a premium finance loan will often be nonrecourse to the insured. STOLI-based nonrecourse premium finance was sold as essentially riskless for the insured, but insurance company pushback and insurable interest concerns have drastically reduced the availability of nonrecourse premium financing.<sup>111</sup> Partial-recourse premium financing (e.g. a premium finance loan that is 25% recourse to the insured) has generally replaced nonrecourse premium finance; but partial-recourse premium finance is not always used to facilitate STOLI arrangements. Regardless of the type of premium finance used, in a STOLI arrangement the insured does not intend on purchasing long term life insurance coverage but only intends to hold the policy for the duration of the contestability period. After the contestability period, the insured expects to sell the policy at a profit.<sup>112</sup>

When premium financing is used to fund a STOLI policy, the insured is given three options at the close of the contestability period:

- (1) The insured can take ownership of the policy by paying off the loan, including principal, interest and fees. The loan can be refinanced with another lender or paid off in cash.
- (2) The policy can be sold on the secondary market. The insured will retain any profit on the sale after the premium finance loan and fees are paid off.
- (3) The insured can surrender the policy to the lender in satisfaction of the loan. The lender will then sell the policy on the secondary market.

The insured is very unlikely to take the first option since the insured was probably not in the market for a life insurance policy when entering into the arrangement. Because the first option is effectively off-limits to the insured, the real purpose of the arrangement—moving the life insurance policy into the secondary market—is essentially guaranteed by the STOLI plan.

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<sup>111</sup> See *id.* See also *Lincoln Nat. Life Ins. Co. v. Calhoun*, 596 F.Supp.2d 882, 884-86 (D. N.J. 2009); Eryn Mathews, Notes and Commentaries, *STOLI on the Rocks: Why States Should Eliminate the Abusive Practice of Stranger-Owned Life Insurance*, 14 CONN. INS. L.J. 521, 525-37 (2008).

<sup>112</sup> See *Calhoun*, 596 F.Supp.2d 885.



B. USE OF IRREVOCABLE LIFE INSURANCE TRUSTS IN STOLI ARRANGEMENTS

STOLI policies are often purchased through an irrevocable life insurance trust (ILIT). A premium finance loan will be made to the ILIT, which owns the policy from issuance to maturity. Rather than directly transferring ownership of the policy to investors, the trustee of the ILIT is changed to a trustee chosen by the premium finance company. The beneficiary is also changed so that beneficial ownership and control of the policy passes to the investors without signaling the change to the company that issued the policy.

C. IMPACT OF STOLI ON THE INSURABLE INTEREST REQUIREMENT

A central concern with STOLI arrangements is their relationship with the insurable interest requirement. As discussed in sections II and III, the insurable interest requirement exists to limit the issuance of wager policies and prevent the moral hazard due to the beneficial owner's financial interest in the insured's premature death. In STOLI transactions, the party who is ultimately intended as the beneficial owner of the policy will not have an insurable interest in the insured's life at the time the policy is issued.<sup>113</sup>

In tension with the insurable interest requirement is the well-settled principle that a life insurance policy is freely transferrable once the policy is validly issued. This principle permits an insured to purchase a policy of life insurance and transfer the policy to any person, including someone without an insurable interest, subject to very few restrictions. At first glance, the free transferability of life insurance would seem to vindicate STOLI as a legitimate practice. After all, the insured, who has an unlimited insurable interest in his own life, purchases the policy and exercises his legal right to transfer the policy to whomever he chooses.<sup>114</sup> But the foray

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<sup>113</sup> Although STOLI has received significant bad press in recent years, it is worth noting that the better-received life settlements implicate the same policy concerns motivating the backlash against STOLI arrangements. After all, an investor purchasing a policy in a life settlement has the same incentive to see the insured meet an early death as the investor purchasing a policy issued directly into a STOLI arrangement.

<sup>114</sup> In a small minority of jurisdiction (e.g. New York), lack of an insurable interest does not void a policy, but triggers a procedure for equitable distribution of policy proceeds, the lawsuit will be between investors and the insured decedent's

of the capital markets into life insurance has exploited the tension between the competing policy considerations affecting the insurable interest requirement and has stretched the requirement to the point of breaking.

#### D. RECENT STOLI CASES

##### 1. Phoenix Life v. Lasalle Bank

In the typical modern insurable interest case, an insurance carrier is asking the court to issue a declaration that a life insurance policy held by an investment group is void *ab initio* for lack of an insurable interest. For instance, in *Phoenix Life v. Lasalle Bank*, a decision handed down in 2009 by the U.S. District Court for the Eastern District of Michigan, a life insurance policy was assigned to a lender as security for a nonrecourse premium finance loan. Phoenix, who issued the policy, sought a declaratory judgment that the policy was void *ab initio* for lack of an insurable interest. Coventry, the investment group, argued that Phoenix's motion should be dismissed because, in their view, Phoenix's insurable interest argument was based entirely on the fact that the policy premiums were paid by a premium finance loan. Coventry argued that this fact was insufficient as a matter of law to establish that the policies were issued without an insurable interest. The court disagreed, holding that Phoenix's allegation that the insured purchased the policy with the intent to absolutely assign the policy to Coventry was sufficient to "state a claim for rescission based on the lack of an insurable interest." Under Michigan law, assignment of a validly issued life insurance policy to someone without an insurable interest is permitted. But a complete assignment of an insurance policy made simultaneous with issuance of the policy violates the insurable interest requirement. Such an assignment is void because the assignment is made in bad faith for the purpose of circumventing the insurable interest requirement.<sup>115</sup>

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estate. See e.g. *Life Prod. Clearing LLC v. Angel*, 530 F.Supp.2d 646. See *supra* text accompanying notes 55-56.

<sup>115</sup> *Phoenix Life Ins. Co. v. LaSalle Bank N.A.*, Nos. 2:07-cv-15324, 2009 WL 877684, at \*12 (E.D. Mich. Mar. 30, 2009). See also *AXA Equitable Life Ins. Co. v. Infinity Financial Group, LLC*, 608 F.Supp.2d 1349, 1352-53, 1356-57 (S.D.Fla. 2009) (holding that an assignment of a life insurance policy may not be made where an agreement to assign the policy existed prior to the issuance of the policy or contemporaneously therewith.)

## 2. Sun Life v. Paulson

*Sun Life v. Paulson*, a 2008 Federal District Court of Minnesota case, involved facts similar to those in *Phoenix Life v. Lasalle*. Sun Life brought suit for a declaratory judgment that the policy issued on Paulson's life and subsequently purchased by Coventry was void for lack of an insurable interest. Sun Life's claim was based on their assertion that at the time the insured purchased the policy, he intended to sell the policy to a third party without an insurable interest in Paulson's life. As in *Phoenix Life*, the court considered a motion to dismiss by Coventry.<sup>116</sup>

Assuming the facts of the plaintiff's complaint to be true, including the plaintiff's assertion that the insured purchased the policy with the intent to transfer it to a person without an insurable interest, the court found that the policy was not void for lack of insurable interest.<sup>117</sup> Of primary importance to the court was the fact that there was no evidence that Paulson colluded with anyone else when purchasing the policy. In the court's view, in order for a life insurance policy to be void *ab initio* for lack of an insurable interest, not only must the insured purchase the policy with the intent to transfer the policy to a party without an insurable interest in violation of the good faith requirement, but the policy must be "procured under a scheme, purpose, or agreement to transfer or assign the policy to a person without an insurable interest in order to evade the law against wagering contracts." As a result, if an insured purchases an insurance policy with the intent to transfer the policy to a person without an insurable interest in the insured's life, but the insured has not identified a particular purchaser for the policy, the policy is not void and the transfer is valid. In the district court's view:

Paulson's intent is... irrelevant without facts or allegations suggesting that a third party lacking an insurable interest intended, at the time Paulson procured the [policy], to acquire the policy upon expiration of the contestability period. Likewise, Coventry's later acquisition of the [policy] is irrelevant without similar facts or allegations regarding its intent at the time Paulson procured the insurance.<sup>118</sup>

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<sup>116</sup> *Sun Life Assur. Co. of Canada v. Paulson*, No. 07-3877, 2008 WL 451054, at \*1 (D. Minn. 2008).

<sup>117</sup> *Id.* at \*2.

<sup>118</sup> *Id.*

### 3. Lincoln National Life Insurance Co. v. Calhoun

*Lincoln National Life Insurance Co. v. Calhoun*, arose under facts similar to those in *Paulson* and *Lasalle*. As in *Paulson*, the insured purchased a high-value policy with the intent to sell the policy on the secondary market. The court did not arrive at a holding with respect to whether a scheme is necessary for a policy to be found void *ab initio* for lack of an insurable interest. But, in contrast to *Paulson*, the court denied the defendant's motion for dismissal. The court viewed New Jersey law as unsettled on the question of whether mutual intent—of the insured and a third party without an insurable interest in the insured's life—is necessary for a policy to be found void for lack of an insurable interest or whether unilateral intent of the insured is sufficient. Recognizing that “compelling policy considerations are raised by either position,” the court viewed dismissal of the plaintiff's claim as premature because, the court said, the issues of intent implicated by the case were better decided after the plaintiff had further opportunity to discover whether Calhoun had an arrangement with a particular purchaser when he bought the policy. If Calhoun had an arrangement with a third-party purchaser at the time he purchased the policy, it would be unnecessary for the court to decide the question of whether unilateral intent is sufficient to void the policy since, in that case, mutual intent would be present.<sup>119</sup>

### 4. Summary of the Typical Contemporary Case

Though each of the preceding three cases were decided on motions to dismiss rather than at trial, the decisions are important because they examine the insurable interest requirement in the face of uniquely modern factual allegations while simultaneously reaffirming the importance of the traditional doctrine. *Lasalle* takes the tradition tack, looking for facts indicating that the arrangement was entered into, and the policy purchased, for the purpose of subverting the prohibition on wager policies.<sup>120</sup> *Paulson*, like *Lasalle*, looks for facts indicating that the policy was a wager policy, but narrows the traditional rule by including an additional constraint on its application—the requirement that the policy be issued as part of scheme involving the insured and another person.<sup>121</sup> In light of the policy

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<sup>119</sup> *Lincoln Nat'l. Life Ins. Co. v. Calhoun*, 596 F.Supp.2d 882, 890 (D. N.J. 2009).

<sup>120</sup> *LaSalle Bank N.A.*, 2009 WL 877684, at \*7.

<sup>121</sup> *See Paulson*, 2008 WL 451054, at \*2.

considerations driving the insurable interest requirement, the court in *Paulson* may narrow the insurable interest requirement too far. A policy issued to an insured who, from the beginning, intends on selling the policy to someone without an insurable interest implicates the insurable interest requirement and runs afoul of the prohibition on wager policies to the same extent as policies purchased as part of a “scheme.”

In most of these recent cases, courts have not had to expand the scope of the insurable interest requirement or otherwise alter its applicability to successfully target and strike down STOLI transactions. The courts have, for the most part, stuck to the narrow historical definition of insurable interest, though *Paulson* did put a new spin on the insurable interest requirement by substantially narrowing it when applied to a STOLI policy. With the exception of the Parduhn case, discussed below, courts have consistently required the existence of an insurable interest at a single point in time, issuance of the policy, rather than requiring the existence of an insurable interest on a continuum running from issuance of the policy to its maturity.

#### 5. An Anomalous Case —Insurable Interest Required from Policy Issuance to Maturity

##### *a. Parduhn v. Bennett*

*Parduhn v. Bennett* and the Utah insurable interest statute under which the case was decided are an anomaly in modern insurable interest law.<sup>122</sup> Rather than requiring an insurable interest only at a policy’s issuance, the Supreme Court of Utah interpreted Utah’s insurable interest statute to require a policy’s beneficial owners to have an insurable interest at all times during a policy’s existence, from issuance to maturity.

The case involved partners in a partnership with a buy-sell agreement in place. Under the agreement, if one partner died, the other partner was required to purchase the decedent partner’s partnership interest. The buy-sell agreement was to be funded by proceeds of a life insurance contract. The partners sold their business to a third party without the buy-sell agreement ever being activated and ceased doing business as a partnership. When one partner died, the other partner filed suit to establish his right to the insurance proceeds. In opposition to the surviving partner, the decedent partner’s wife argued that she had a right to the insurance proceeds.

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<sup>122</sup> *Parduhn v. Bennett*, 61 P.3d 982 (Utah 2002).

In many jurisdictions, each partner would likely have had an insurable interest in the other partner's life at the time the insurance contract was purchased, based on their economic relationship. The Utah insurable interest law in force at the time *Parduhn* was decided not only required an insurable interest at the time the policy was issued, but also at the time a policy is transferred to a third party and when the policy matured. The Utah Code stated that "[a] person may not knowingly procure, directly, by assignment, or otherwise, an interest in the proceeds of an insurance policy unless that person has or expects to have an insurable interest in the subject of the insurance."<sup>123</sup> This provision was interpreted to mean that a person is not permitted to have an interest in insurance policy proceeds unless that person has an insurable interest in the insured's life.<sup>124</sup>

In addition to requiring an insurable interest at the time at transfer and at maturity, the statute specifically limited a partner's insurable interest in another partner's life to situations involving a legitimate buy-sell agreement. Without a buy-sell agreement, there was no insurable interest, regardless of any other economic relationship between the partners.<sup>125</sup>

Based on the Utah insurable interest statute in force at the time the case was decided, the Utah Supreme Court held that the surviving partner was not entitled to the life insurance policy's death benefit because the buy-sell agreement was no longer in place when the policy reached maturity, and the partner was not permitted to receive the death benefit without an insurable interest in the deceased partner's life. By so holding, the Utah court broke with the common law and statutes in force in every other jurisdiction by effectively requiring the existence of an insurable interest on a continuum from issuance of the policy to its maturity.

The impact of *Parduhn*'s anomalous holding was limited fairly quickly by the Utah state legislature, which brought the state's insurable interest law into conformity with the rest of the country.

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<sup>123</sup> UTAH CODE ANN. § 31A-21-104(1)(b) (2005) (current version at UTAH CODE ANN. § 31A-21-104 (Supp. 2010)).

<sup>124</sup> See *Parduhn v. Bennett*, 61 P.3d 982, 986-87 (Utah 2002); See also Harbor Funds, LLC, Utah Div. Sec., No-Action or Interpretive Letter, 2002 WL 31746494, at \*2 (Nov. 6, 2002) (opinion rescinded Oct. 4, 2010 to reflect subsequent amendments to the Utah Uniform Securities Act that classify life settlements as securities even before they are sold in the secondary market).

<sup>125</sup> UTAH CODE ANN. § 31A-21-104(1)(b), (2)(a) (2005) (current version at UTAH CODE ANN. § 31A-21-104 (Supp. 2010)). Note that in Utah, a policy issued without an insurable interest is not void or even voidable, but the death benefit will not be paid to the named beneficiary. Rather, policy proceeds will be equitably distributed by the court. UTAH CODE ANN. § 31A-21-104(6)(b) (Supp. 2010).

*b. Utah's Amended Insurable Interest Statute*

The situation in *Parduhn* would not likely have the same result if the case were decided under the current Utah insurable interest statute. A 2007 amendment to Utah's insurable interest law<sup>126</sup> specifies that, in the case of a life insurance policy, an insurable interest need only exist on the date the policy is issued and at any later time when an interest in the policy is transferred or assigned. The insurable interest requirement need not be met at the time the policy proceeds are payable. Because *Parduhn* had an insurable interest in his partner's life and the policy was never transferred or assigned, *Parduhn* would not be required to have an insurable interest in his partner's life at the time the death benefit was paid and the payment could properly be made to *Parduhn*.

The statute probably also eliminates the absolute restriction on a partner's insurable interest to situations where a legitimate buy-sell agreement exists. While that restriction was formerly included in the definition of "insurable interest," the amended statute indicates that the former restriction is now part of a nonexclusive list of situations where an insurable interest exists. In other words, a partner's insurable interest based on a legitimate buy-sell agreement is only one example of a situation where a partner would have an insurable interest in another partner's life. Other circumstances presenting an insurable interest in a partner's life certainly exist.

**VIII. MISREPRESENTATIONS ON THE POLICY APPLICATION**

Though a significant portion of the dialog surrounding STOLI has centered on the insurable interest requirement, other issues are often litigated together, creating a *mélange* of related but distinct concepts and prohibitions affecting the validity of a life insurance contract. In addition to an insurer's claims for rescission due to lack of an insurable interest, carriers also typically seek rescission of the policy based on intentional misrepresentations made on the policy application. Many recent STOLI cases raise the issue of misrepresentation on the policy application in addition to lack of an insurable interest. Other than the insurable interest requirement, an insurer's right to rescind a life insurance contract based on misrepresentations made on the policy application remains the strongest enforcement mechanism available to combat STOLI.

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<sup>126</sup> Utah's insurable interest statute explicitly permits viatical and life settlements. UTAH CODE ANN. § 31A-21-104(7) (Supp. 2010).

An insurer who becomes aware of a misrepresentation made on a policy application may generally rescind the policy by notifying the insured of the rescission and refunding any premiums paid.<sup>127</sup> An insurer may also sue for rescission of the policy or assert the rescission as a defense to an action on the policy. In the alternative, an insurer may also assert misrepresentation as a defense against a beneficiary's suit seeking payment of the policy death benefit after the insured death.<sup>128</sup>

Generally, a life insurance policy is voidable by the carrier if the insured made material misrepresentations on the application for insurance. An innocent misrepresentation is sufficient grounds for rescission of a policy; it is not necessary that the misrepresentation be made intentionally or in bad faith.<sup>129</sup> A misrepresentation or omission is "material" if the misrepresentation or omission "can be understood to reasonably affect an insurer's decision to enter into the insurance contract."<sup>130</sup> In other words, the test for materiality is subjective; a misrepresentation is material if it affects the insurer's risk in entering into the contract or the amount of premiums to be charged on the policy is material.<sup>131</sup> Materiality is not determined under an objective, reasonable insurer standard.<sup>132</sup>

The policy application and the questions included therein by the insurer may be probative of materiality, since the insurer presumably chose the questions for the purpose of gauging risk and setting policy premiums. Because "[m]ateriality is determined solely by the probable and reasonable effect which truthful answers would have had upon the insurer[, t]he fact that the insurer has demanded answers to specific questions in an application for insurance is in itself usually sufficient to establish materiality as a matter of law."<sup>133</sup>

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<sup>127</sup> N. Y. Life Ins. Co. v. Marshall, 23 F.2d 225, 225 (5th Cir. 1928).

<sup>128</sup> Erie Ins. Exch. v. Lake, 671 A.2d 681, 686-87 (Pa. 1996); Feierman v. Eureka Life Ins. Co., 124 A. 171, 171-72, (Pa. 1924).

<sup>129</sup> John Hancock Mut. Life Ins. Co. v. Weisman, 27 F.3d 500, 504 (10th Cir. 1994) (applying New Mexico law).

<sup>130</sup> *Id.* at 506; Lincoln Nat. Life Ins. Co. v. Calhoun, 596 F.Supp.2d 882, 887 (D.N.J. 2009).

<sup>131</sup> *Calhoun*, 596 F.Supp.2d at 887-88.

<sup>132</sup> Matilla v. Farmers New World Life Ins., 960 F. Supp. 223, 226 (N.D. Cal. 1997), *aff'd*, 133 F.3d 927 (9th Cir. 1997). *See also* ALLEN D. WINDT, INSURANCE CLAIMS AND DISPUTES § 2:26, at 110-19 (5th ed. 2007).

<sup>133</sup> Thompson v. Occidental Life Ins. Co., 513 P.2d 353, 360 (Cal. 1973). *See also* LA Sound USA, Inc. v. St. Paul Fire & Marine Ins. Co., 156 Cal. App. 4th 1259, 1266-69, Cal. Rptr.3d 917, 920-24 (2007). *See generally* WINDT, *supra* note 132, at 110-117.



Issues of misrepresentation are often intertwined with the insurable interest issue because carriers frequently include questions on policy applications that are intended to ferret out STOLI transactions that are formulated to do an end-run around the insurable interest requirement.<sup>134</sup> For instance, the application on which the policy in *Phoenix Life v. Lasalle* (discussed *supra*) was issued included four such questions:<sup>135</sup>

- (1) Is “non-recourse premium financing or any other method being utilized to pay premiums in order to facilitate a current or future transfer, assignment or other action with respect to the benefits provided under the policy being applied for”?
- (2) Is there “an intent to finance any of the premiums”?
- (3) Is “the current intent... to sell the policy in the future”?
- (4) Has there “been any inducement to enter into this transaction”?

Each of the preceding four questions seeks to determine whether the insured is purchasing the policy as part of a STOLI arrangement by looking for signals that the policy is being purchased with an intent to obfuscate a violation of the insurable interest requirement. An insured who purchases a policy as part of a STOLI transaction will be forced to make a misrepresentation when answering these questions or face rejection of his or her application by the insurer. The insurer can avoid the policy at issuance by declining to issue the policy if the insured answers the questions truthfully, and may avoid the policy after issuance by rescinding the policy if the insured makes misrepresentations on the application.

The insurer is in the best position to determine whether a policy is being issued in violation of the insurable interest requirement. As discussed above, in most cases, an insurer has the opportunity to rescind a policy or seek a determination that the policy is void throughout the entire life of the policy—from the date the policy is issued to after the insured’s death. And

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<sup>134</sup> Though the insurable interest requirement is often intertwined with claims of misrepresentation, the two issues are distinct. Of particular importance is the fact that an insurer is time barred from suing for rescission based on misrepresentation when the contestability period has passed, but is not time barred from seeking a declaration that the policy is void for lack of an insurable interest. See *supra* text accompanying notes 58-62.

<sup>135</sup> *Phoenix Life Ins. Co. v. LaSalle Bank N.A.*, 2009 WL 877864, at \*1 (E.D.Mich. Mar. 30, 2009).

the insurer has tremendous power to craft policy applications to discover whether an insured is purchasing a policy for an improper purpose.

Determination that a policy was issued without an insurable interest has a devastating effect on the property rights of the insured, transferees and beneficiaries: such failure voids the policy, extinguishing it as if it never existed.<sup>136</sup> Tampering with the insurable interest requirement thus impacts all policy owners, introducing a level of uncertainty into a policy purchase. In contrast, aiming anti-STOLI enforcement efforts at the misrepresentations necessarily made on a well-crafted policy application when a policy is being purchased as part of a STOLI transaction targets only those parties making misrepresentations. As such, policymakers should be reticent about strengthening or otherwise altering the insurable interest requirement when other enforcement mechanisms—a well-designed policy application and misrepresentation detection—offer a targeted, flexible approach to combating STOLI.

#### IX. NAIC AND NCOIL MODEL CODES AND THEIR AFFECT ON THE INSURABLE INTEREST REQUIREMENT

States have been increasingly interested in supplementing established insurable interest law with statutes designed to identify and prohibit nascent types of transactions that violate the spirit, if not the letter, of the insurable interest requirement.<sup>137</sup> Two model statutes, both regulating life and viatical settlements, have been recently amended to supplement and strengthen this requirement. Prompted by increased attention on STOLI, the National Conference of Insurance Legislators (NCOIL) and the National Association of Insurance Commissioners (NAIC)<sup>138</sup> amended their respective model codes in 2007. Each model act has been adopted by a number of states, with some states choosing to adopt a hybrid approach incorporating elements from both acts.<sup>139</sup>

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<sup>136</sup> See *supra* Part III.

<sup>137</sup> See Leimberg, *supra* note 104, at 3.

<sup>138</sup> The NAIC has published hundreds of model laws covering every aspect of life insurance regulation, many of which have been enacted by state legislatures.

<sup>139</sup> Ariella Gasner, Note, *Your Death: The Royal Flush of Wall Street's Gamble*, 37 HOFSTRA L. REV. 599, 626-628 (2008-2009).

## A. NCOIL'S VIATICAL SETTLEMENTS MODEL ACT

NCOIL adopted the Life Settlements Model Act in 2000 as an alternative to the NAIC model and amended the act in 2007 to address concerns with STOLI.<sup>140</sup> The NCOIL model includes three primary components: (1) a recommendation that states amend their insurable interest laws to cover modern permutations on the wager policy, (2) a definition and prohibition of STOLI, and (3) a moratorium on life settlements running two years after issuance of a policy.

## 1. Amend State Insurable Interest Statutes

NCOIL's approach to STOLI strengthens and uses traditional tools to combat wager policies, including the insurable interest requirement. Some commentators have expressed concern that the traditional insurable interest requirement is ill-suited to the modern environment in which STOLI has sprung up. Recognizing this potential weakness, a drafting note to the NCOIL 2007 Life Settlements Model Act recommends that states "amend their insurable interest laws, if necessary, to provide additional protection against trust-initiated STOLI and other schemes involving a cloak." The model act goes on to suggest a proposed statutory amendment that would specifically strike at premium financing arrangements intended to effectuate investor ownership of a life insurance policy:<sup>141</sup>

In accordance with *Grigsby v. Russell*, 222 U.S. 149, it shall be a violation of insurable interest for any person or entity without insurable interest to provide or arrange for the funding ultimately used to pay premiums, or the majority of premiums, on a life insurance policy, and, at policy inception have an arrangement for such person or entity to have an ownership interest in the majority of the death benefit of that life insurance policy.

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<sup>140</sup> Press Release, Nat'l Council of Ins. Legislators, NCOIL Closes In On Illegal STOLI, Unanimously Adopts Amended Model Act (Nov. 20, 2007), available at <http://www.ncoil.org/HomePage/2007/LifeSettlementsPR.pdf>.

<sup>141</sup> LIFE SETTLEMENTS MODEL ACT, (Nat'l Council of Ins. Legislators, Drafting Note 2007).

## 2. STOLI Definition

Like the NAIC model act and the traditional prohibition on wager policies, the NCOIL model act prohibits anyone from entering into a life settlement<sup>142</sup> prior to issuance of the policy and provides for a period during which most life settlements are prohibited.<sup>143</sup>

In contrast to the NAIC model, which does not mention STOLI by name and does not define it, the nucleus of the NCOIL model is its definition of STOLI. The model act defines “STOLI” as follows: “STOLI is a practice or plan to initiate a life insurance policy for the benefit of a third party investor who, at the time of policy origination, has no insurable interest in the insured.”<sup>144</sup>

This definition essentially restates the black-letter law (*see supra*) prohibiting arrangements intended to subvert the insurable interest requirement. Going further, NCOIL’s definition also ropes in some transactions that are not explicitly covered by traditional insurable interest cases and statutes:<sup>145</sup>

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<sup>142</sup> The NCOIL model act defines “life settlement contract” in essentially the same way as the NAIC model act defines “viatical settlement contract” with some minor differences. *Compare* LIFE SETTLEMENTS MODEL ACT § 2(L) (Nat’l Council of Ins. Legislators 2007) (defining “life settlement contract” as “a written agreement entered into between a Provider and an Owner, establishing the terms under which compensation or any thing of value will be paid, which compensation or thing of value is less than the expected death benefit of the insurance policy or certificate, in return for the owner’s assignment, transfer, sale, devise or bequest of the death benefit or any portion of an insurance policy or certificate of insurance for compensation, provided, however, that the minimum value for a Life Settlement Contract shall be greater than a cash surrender value or accelerated death benefit available at the time of an application for a Life Settlement Contract.”), *with* VIATICAL SETTLEMENTS MODEL ACT § 2(N)(1) (Nat’l Ass’n of Ins. Comm’rs 2010) (defining “viatical settlement contract” as “a written agreement establishing the terms under which compensation or anything of value is or will be paid, which compensation or value is less than the expected death benefits of the policy, in return for the viator’s present or future assignment, transfer, sale, devise or bequest of the death benefit or ownership of any portion of the insurance policy or certificate of insurance.”).

<sup>143</sup> LIFE SETTLEMENTS MODEL ACT § 11(N) (Nat’l Council of Ins. Legislators 2007).

<sup>144</sup> LIFE SETTLEMENTS MODEL ACT § 2(Y) (Nat’l Council of Ins. Legislators 2007).

<sup>145</sup> *Id.*

STOLI practices include but are not limited to cases in which life insurance is purchased with resources or guarantees from or through a person, or entity, who, at the time of policy inception, could not lawfully initiate the policy themselves, and where, at the time of inception, there is an arrangement or agreement, whether verbal or written, to directly or indirectly transfer the ownership of the policy and/or the policy benefits to a third party.

This definition sharpens the insurable interest requirement by covering indirect arrangements intended to shift a policy from an insured to investors, like nonrecourse premium financing.

### 3. Two-Year Moratorium on Life Settlements

The NCOIL model's two-year moratorium prohibits life settlement transactions for a two year period following issuance of the policy. This two-year ban on transfers is significantly shorter than the NAIC's five-year ban. Like the NAIC model, the NCOIL model provides exceptions to the two-year moratorium.<sup>146</sup>

#### B. THE NAIC VIATICAL SETTLEMENTS MODEL ACT

The NAIC issued the Viatical Settlements Model Act<sup>147</sup> in 1993 in response to perceived abuses in the viatical settlement industry. Subsequently, in 2007 the NAIC adopted a revised model act to take into account significant changes in the industry, including the increasing prevalence of STOLI. In contrast NCOIL's targeted approach, which defines and prohibits STOLI, NAIC's model act attempts to strike at the economic foundations of STOLI transactions.

Rather than define "STOLI," the NAIC model act defines "viatical settlement" and proscribes a set of "prohibited practices" with respect to those viatical settlements. The model act defines "viatical settlement contract" as:<sup>148</sup>

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<sup>146</sup> *Id.* § 11(N).

<sup>147</sup> Originally the model was entitled "Living Benefits Model Act." The working group decided to change the title to "Viatical Settlements Model Act."

<sup>148</sup> VIATICAL SETTLEMENTS MODEL ACT § 2(N)(1) (Nat'l Ass'n of Ins. Comm'rs 2010).

[A] written agreement establishing the terms under which compensation or anything of value is or will be paid, which compensation or value is less than the expected death benefits of the policy, in return for the viator's present or future assignment, transfer, sale, devise or bequest of the death benefit or ownership of any portion of the insurance policy or certificate of insurance.

By definition, "viatical settlement contract" thus includes not only what are traditionally known as viatical settlements, but also life settlements and STOLI arrangements. Many premium finance transactions are also explicitly categorized as viatical settlements under the act.<sup>149</sup>

The first layer of defense against STOLI in the NAIC model act is its prohibition of any person from entering "into a viatical settlement at any time prior to the application or issuance of a policy which is the subject of viatical settlement contract."<sup>150</sup> This provision is essentially a statutory enactment of the long-standing law in most jurisdictions: Entering into an agreement to purchase and assign a policy is an attempt to subvert the insurable interest requirement and amounts to a prohibited wager policy.<sup>151</sup>

The second, and most controversial, component of the model act's anti-STOLI provisions is its moratorium on life settlements in the five years after a policy's issuance. This component essentially supplements the insurable interest requirement by attacking the economic incentives driving investment in STOLI policies. Requiring a five-year wait before assignment of a policy increases the mortality risk inherent in the policy, thus reducing investors' rates of return and diminishing their incentive to use STOLI to enter the mortality markets.<sup>152</sup>

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<sup>149</sup> VIATICAL SETTLEMENTS MODEL ACT §1(N)(2) . (Nat'l Ass'n of Ins. Comm'rs 2010). Covered premium finance loans includes loans made where (1) proceeds of the loan are not used solely to cover the policy's premiums and fees, (2) the loan includes a guaranteed future viatical settlement value for the policy, or (3) the viator or insured agrees at the time the policy is issued to sell the policy at some future date.

<sup>150</sup> VIATICAL SETTLEMENTS MODEL ACT §11(A) (Nat'l Ass'n of Ins. Comm'rs 2010).

<sup>151</sup> See e.g. *Warnock v. Davis*, 104 U.S. 775, at 779 (1881); *Cammack v. Lewis*, 82 U.S. 643, at 648 (1872).

<sup>152</sup> Life Ins. Settlement Ass'n, *NAIC Model Act*, <http://www.lisassociation.org/lifesettlementtruth/NAIC.html> (last visited Sept. 15, 2010).

Recognizing that a blanket five-year prohibition on life settlements could harm consumers who develop a need to sell a policy during that five-year period, the Viatical Settlements Model Act includes a number of exceptions to the five-year moratorium on life-settlements. The first category of exceptions permits a life settlement in a number of situations involving major life changes, such as when the insured is “terminally or chronically ill,” when the insured’s marriage ends due to death or divorce, or when the insured retires from full-time employment.<sup>153</sup> The model act also permits a settlement two years after a policy is issued as long as the insured has not been evaluated for settlement during the two-year period and, if applicable, only traditional premium finance was used to fund premium payments and fees associated with the policy.<sup>154</sup>

### C. RESPONSE TO THE MODEL ACTS

Some commentators and industry groups, like the Life Insurance Settlement Association (LISA) and NCOIL, worry that the NAIC approach amounts to an interference with the well-established property rights associated with life insurance policies. They worry that the exceptions to the five-year moratorium on life settlements do not go far enough to exempt legitimate settlement transactions from being categorized as impermissible life settlements.<sup>155</sup> This, they argue, undercuts the insured’s property right in the policy and harms an insured who experiences unexpected financial difficulty in the two-year period following issuance of the policy. An insured who does not satisfy one of the exceptions to the five-year moratorium will be unable to sell the policy in the first two years after the policy is issued and will be forced to let the policy lapse or accept

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<sup>153</sup> VIATICAL SETTLEMENTS MODEL ACT §11(A)(2) (Nat’l Ass’n of Ins. Comm’rs 2010)..

<sup>154</sup> *Id.* §11(A)(3). A third exception to the five-year moratorium on settlements is for policies issued as a result of the insured’s exercise of conversion rights in a policy. *Id.* §11 (A)(1).

<sup>155</sup> Life Ins. Settlement Ass’n, *NAIC Model Act*, <http://www.lisassociation.org/lifesettlementtruth/NAIC.html> (last visited Jan. 7, 2010). A legitimate life settlement transaction is a transaction entered into by an insured who, sometime after purchasing a life insurance policy to satisfy the his or her need for life insurance, transfers the policy to a third-party because the policy is no longer needed or because other financial needs outweigh the insured’s need for a life insurance policy. Transfer of a policy to a third party when the policy was purchased with the intent to transfer it to a third party is, under the Model Act, not a legitimate life settlement transaction.

the surrender value of the policy.<sup>156</sup> This, they argue, severely undercuts the utility of a policy in the initial years of its existence.<sup>157</sup>

The NAIC model act has also been characterized as an attack on the entire secondary market rather than a focused approach to eliminating STOLI. NCOIL has characterized the NAIC model act as creating “harsh barriers for consumers seeking to sell their policies and burdens for life settlement companies seeking to act in the life settlement market.”<sup>158</sup> Critics view the model act as condemning all premium financed policies and life settlements but then exempting some transactions from the group of prohibited transactions. This exceptions-based approach is also criticized as providing “opportunities” to circumvent the law by crafting STOLI transactions that satisfy the exceptions.<sup>159</sup>

Other commentators have dismissed criticisms of the NAIC model act as exaggerations of a few isolated instances where an insured will not be permitted to engage in what would otherwise be a life settlement. In

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<sup>156</sup> One suggested amendments to the NAIC model act includes a provision explicitly exempting insureds from the five-year moratorium if the insured has experienced a sudden decrease in net worth. This amendment has not been incorporated into the act.

<sup>157</sup> In a letter to NCOIL, Doug Head, LISA Executive Director, stated that the solution to the STOLI problem lies in state insurable interest statutes rather than in upturning established law. He also expressed concerns with the five-year moratorium, believing that it “harms legitimate life settlements” while failing to address STOLI. In his view, the NAIC model paints with too broad a brush, not only catching legitimate life settlement transactions, but also missing a significant number of STOLI transactions. Also commenting on the NCOIL approach, Representative George J. Keiser, of the North Dakota State Legislature, stated that “STOLI occurs at the front-end of a life insurance sale. By defining STOLI, and strengthening reporting requirements and penalties for participating in STOLI, the NCOIL model gets at the heart of what needs to change. We hope that states considering amendments to existing laws, or new life settlements statutes, will be well-served by the NCOIL proposal.” Press Release, Nat’l Conference of Ins. Legislators, NCOIL Closes in on Illegal STOLI, Unanimously Adopts Amended Model Act (Nov. 20, 2007), available at <http://www.ncoil.org/HomePage/2007/LifeSettlementsPR.pdf>.

<sup>158</sup> Nat’l Conference of Ins. Legislators, *Effective Methods to Stop STOLI*, [http://www.lisassociation.org/lifesettlementtruth/ban\\_STOLI.html](http://www.lisassociation.org/lifesettlementtruth/ban_STOLI.html) (last visited Sept. 15, 2010).

<sup>159</sup> Laura Graesser, *What's Going On in the Life Insurance Business: Regulating Life Settlements*, LIFE INS. SELLING, apr. 2008, at 8, available at <http://www.lifeinsuranceselling.com/Issues/2008/4/Pages/What-s-Going-On-Regulating-Life-Settlements.aspx>.



their view, the five-year moratorium is an absolute bar that will instantly eliminate most STOLI transactions. They argue that the right to sell or assign a life insurance policy has never been absolute, and that the right to transfer a life insurance policy has always been weighed against the potential harm created by permitting such an assignment. Any restriction on an insured's rights to assign a policy must be weighed against the harm caused by STOLI, they argue, and any harm created by the NAIC approach is far outweighed by its benefits.<sup>160</sup>

The recent enactment of NCOIL-influenced statutes by New York<sup>161</sup> and California<sup>162</sup> may signal a momentum shift from the NAIC model to the NCOIL model, but the dust is still settling. Regardless of how the battle between the two predominant model codes plays out, the coming decade is likely to see a further honing of insurable interest statutes as state legislatures wrestle with STOLI and its progeny. Like the mid 19<sup>th</sup> century, the early 21<sup>st</sup> century is likely to be viewed as a seminal, innovative period for life insurance and the laws shaping and defining its boundaries.

## X. CONCLUSION

The current debate over the insurable interest requirement has too often transmuted the moral hazard of the eighteenth century scoundrel, Wainwright, into the latest object of Wall Street's insatiable greed. The historic context within which the insurable interest doctrine formed cannot so simply be analogized to the current policy discussions. Though the Grisby Court's forward-thinking enunciation of the insurable interest doctrine has been black-letter law for nearly a century, Justice Holmes certainly could not have foreseen the radical changes in the life insurance industry or imagined the emergence of the asset-backed securities markets.

At the beginning of the 20<sup>th</sup> century, life insurance products consisted of little more than straight forward life insurance and the basic annuities. The vast expansion of property rights unleashed by *Grisby*'s clarification of assignment principles applied to insurance products has inured to the benefit of both insurers and insureds in the form of much more marketable products that have savings components and free alienability.

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<sup>160</sup> Adam S. Flood, *Stranger-Originated Life Insurance: How the NAIC Tamed an Old Dog with a New Trick* (2008), available at SSRN: <http://ssrn.com/abstract=1162492>.

<sup>161</sup> N.Y. LEGIS. Law § 78 (2010).

<sup>162</sup> CAL.INS.CODE §§ 10113.1(g)(1)(B), (w) (West Supp. 2010).

Recent initiatives addressing the abuses of the historic insurable interest concept as life insurance has been morphed into a capital markets product must be viewed in the context of the vastly different bundle of rights modern insurance policies commonly contain. Any proposal to modify insurable interest statutes that too greatly abrogates consumers' property rights in their insurance policies must be viewed as circumspect, if those same initiatives can also be construed as protecting insurance companies' monopsonistic pricing power.

While the *Grisby* court understood financial institutions such as insurance companies would profit from insured's living long, and also from earlier death in the case of annuities, any legislative proposals should not weaken insurable interest concepts so as to leave insured's exposed to the moral failings of modern-day Wainwright. Nor can the new profit motive injected into the insurance markets by Wall Street's securitization markets be allowed to create new incentives to push and parse the boundaries of insurable interest statutes. New insurable interest legislation must incorporate a restrained and balanced effort to reign in abuses of the insurable interest doctrine, and the fraudulent practices effectuating those abuses, without unduly curtailing the advantages of modern insurance products.

Some efforts to curb STOLI abuses, such as NCOIL's Viatical Settlements Model Act, and many recent court cases have taken a restrained approach to the insurable interest requirement, recognizing that a radical expansion of the insurable interest requirement is unnecessary, even in the face of modern insurance products and transactions (e.g. STOLI) without analogue at the doctrine's inception. This conservative approach to the insurable interest requirement is wise considering the drastic effect a failure of the insurable interest has on a policy, voiding it and entirely eliminating its value. Moreover, the careful crafting policy applications in an effort to expose abusive transactions or force the policy owners to make a material misrepresentation and risk holding a void or voidable policy needs to be used as an equal tool in combating such abuses. This restrained and multi-faceted approach has the further benefit of targeting offending transactions without affecting the property rights of other policy owners. The insurable interest requirement has existed for over two centuries, but is still well-equipped to serve the purpose for which it was intended: eliminating wager policies and curbing the moral hazard inherent when speculators insure the lives of unrelated third parties.



## RATING DEPENDENT REGULATION OF INSURANCE

John Patrick Hunt\*

*Solvency regulation lies at the heart of insurance regulation and, at least for now, credit ratings lie at the heart of solvency regulation. Insurance regulators in the United States have used credit ratings extensively to determine what types of investments insurance companies can make and to determine how risky insurers' investments are. Because the insurance regulation system has been so dependent on ratings, high ratings allowed insurers in several different contexts to invest in novel financial products. When these products suffered rating downgrades and losses, the insurers suffered results ranging from stressful (the life insurance industry's need to raise billions of dollars in additional capital) to disastrous (the collapse of AIG and the entire bond insurance industry). Indeed, the latter set of events presented a serious challenge to the conventional wisdom that insurers do not pose systemic risk.*

*Complete removal of credit ratings or analogous private credit assessments from insurance regulation is difficult for both political and substantive reasons. This Article suggests an alternative approach: a "seasoning requirement" for credit ratings on novel products, under which credit ratings on novel products would not be given regulatory effect for some period of time, perhaps one economic cycle. Given that many novel financial products failed immediately in the recent downturn, a seasoning requirement would have avoided the most serious drawbacks of rating-dependent regulation while presenting much less significant political, theoretical, and practical challenges than approaches that rely on completely eliminating dependence on credit ratings or analogous measures.*

### I. INTRODUCTION

The apparent failure of credit ratings on novel products and insurance regulators' response to that failure highlights the limits of regulators' will and desire to wean themselves from credit ratings, as well as the limits of capital regulation itself. After an overview of the

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background, this Article surveys the regulatory response as of early April 2011 to the perceived failure of ratings in the recent financial crisis, identifying a persistent conflict between insurance regulators – who want to rely heavily on credit ratings – and rating-agency reformers, who want to eliminate rating-dependent regulation. The National Association of Insurance Commissioners apparently intends to retain rating-dependent regulation, at least in some form, while the Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted in July 2010, directs federal regulators to eliminate their reliance on ratings. . Absent a Congressional takeover of this historically state-dominated area, the conflict is likely to persist, and so is a high level of rating-dependent in the insurance industry. This is important, not least because insurers are arguably the most important single segment of investors in credit-rated instruments: As of mid-2010, insurers owned about half the dollar value of corporate bonds outstanding in the United States.<sup>1</sup>

The Article then turns to some specific areas in which ratings are perceived to have failed – ratings on exposures taken by AIG and bond insurers, and ratings on residential mortgage-backed securities held by life insurance corporations. In the former case, rating failure led to systemic risk. In the latter, it led to a “rule bailout” – a change in the rules in the midst of a financial crisis undertaken in response to industry requests to aid its position. Both have implications for the broader debate beyond rating-dependent regulation – the broad-ranging consequences of the AIG and bond insurer failures challenge the premise that insurers do not pose systemic risks. The rule bailout illustrates important fundamental limits on capital regulation that should be taken into account in designing capital requirements. Apart from these broader lessons, these situations have implications for rating-dependent regulation of insurance. In both cases, regulators’ practice of giving immediate effect to ratings on novel products contributed to the problems.

A seasoning period—a period in which ratings on a new product are not given regulatory effect – is a measured approach to addressing the problems with rating-dependent regulation. It recognizes regulators’ and regulated parties’ interests in rating reliance and the adequacy of most ratings for regulatory tasks, while avoiding the most serious problems that rating-dependent regulation apparently has produced.

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<sup>1</sup> Federal Reserve Board, Federal Reserve Statistical Release Z.1, “Flow of Funds Accounts of the United States,” June 10, 2010.

## II. WHAT IS SOLVENCY REGULATION AND WHY DOES THE INSURANCE INDUSTRY NEED IT?

Insurance works because people believe insurers' promises to pay. When insurers become insolvent, those promises are likely to be broken, undermining the purpose and function of the industry. Solvency regulation can in principle reduce the harm from insurer insolvencies, both by reducing the number of insolvencies and mitigating the effects of insolvencies that do occur.

### A. OVERVIEW OF INSURANCE SOLVENCY REGULATION

Solvency regulation lies at the heart of insurance regulation.<sup>2</sup> The 1794 statute establishing the first U.S. insurer organized as a stock corporation limited the new company to investment in specified government bonds. Massachusetts adopted a general financial reporting requirement for insurers, aimed at helping customers avoid companies at risk of insolvency, in 1818,<sup>3</sup> and NAIC's first mission after its creation in 1871 was to work on nationally uniform standards for financial reporting to state commissioners.<sup>4</sup> Rules for reserves to cover policy losses followed by the 1870s,<sup>5</sup> and solvency-related limits on investments began to appear as early as 1906.<sup>6</sup> Increases in the stringency of solvency regulation typically

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<sup>2</sup> See EMMETT J. VAUGHAN & THERESE VAUGHAN, *FUNDAMENTALS OF RISK AND INSURANCE* 106 (10th ed. 2008) ("Clearly, a primary focus of insurance regulation is on insurer solvency. Indeed, it has been argued that this should be the primary function of regulation."); ALBERT H. MOWBRAY ET AL., *INSURANCE: ITS THEORY AND PRACTICE IN THE UNITED STATES* 519 (6th ed. 1969) ("The prime purpose of governmental supervision [of insurance] is *solvency*, the continuing financial ability of insurers to meet their contractual obligations.") (emphasis in original).

<sup>3</sup> See KENNETH J. MEIER, *THE POLITICAL ECONOMY OF REGULATION: THE CASE OF INSURANCE* 51 (1988).

<sup>4</sup> Martin F. Grace & Robert W. Klein, *The Future of Insurance Regulation: in THE FUTURE OF INSURANCE REGULATION IN THE UNITED STATES* 1., 32 (Martin F. Grace and Robert W. Klein eds., 2009).

<sup>5</sup> See MEIER, *supra* note 23, at 56.

<sup>6</sup> *Id.* at 58 (describing New York's adoption of investment limits in response to 1906 Armstrong Report). The first investment limits for insurance companies appeared even earlier: The 1794 Pennsylvania statute establishing the first insurance stock corporation in the United States required the insurer to invest only in government bonds, but this requirement may have had to do with shoring up

followed high-profile insolvency episodes, such as the mass failure of insurers after the 1871 Chicago Fire and 1872 Boston Fire.<sup>7</sup>

Solvency regulation as currently constituted includes several interlocking areas.<sup>8</sup> Insurers are required to file quarterly and annual reports on their financial condition to regulators, using specially prescribed statutory accounting standards to do so. Insurance regulators scrutinize these financial statements using special tools<sup>9</sup> and confidential financial tests, and additionally conduct periodic on-site inspections of insurers' operations. Insurers are required to maintain reserves to pay claims and, in addition, are required to meet capital requirements intended to make sure that the insurer has a financial cushion against various misfortunes, such as greater-than-expected insurance losses and adverse interest rates moves. Solvency regulation attempts to limit the negative effects of insolvency by requiring prompt regulatory action to close insolvent insurers before their problems deepen and by providing for state-level guarantee funds to compensate disappointed policyholders for at least a portion of their insolvency-related losses.

Insurers invest the premiums they receive in order to be able to pay claims and make profits, and insurer investment activities are central to solvency regulation. The likelihood of investment losses figures into the size of the required capital cushion and state investment laws outright forbid investments that are judged too risky.<sup>10</sup> Currently, credit ratings are used extensively in both contexts, as described below.

#### B. JUSTIFICATION FOR SOLVENCY REGULATION

Manufacturing firms, restaurants, and law firms are not subject to solvency regulation. One might assume that insurers generally wish to remain in business and thus have strong incentives to remain solvent on their own. Why should insurers be regulated for solvency?

When phrased in economic terms, the answer usually is put in

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shaky post-Revolution public finances than protecting the company's solvency.

<sup>7</sup> *Id.* at 52.

<sup>8</sup> See generally VAUGHAN & VAUGHAN, *supra* note 24, at 106-09; Grace & Klein, *supra* note 43, at 38-40.

<sup>9</sup> The "Financial Analysis Solvency Tools" developed by NAIC are one example. See Martin Eling & Ines Holzmüller, *An Overview and Comparison of Risk-Based Capital Standards*, 26 J INS. REG. 31, 34 (2008).

<sup>10</sup> See Daniel Schwarcz, *Regulating Insurance Sales or Selling Insurance Regulation?: Against Regulatory Competition in Insurance*, 94 MINN. L. REV. 1707, 1736 (2010), *Id.* at 1736 & n.131.

terms of “information asymmetries” (the insurer knows better than the policyholder whether it is solvent, particularly if policyholders are on the whole unsophisticated)<sup>11</sup> exacerbated by an “inverted production cycle” (the insurer can collect premiums for a long time before enough claims materialize to reveal that the firm is insolvent).<sup>12</sup> These characteristics combine with a “collective action problem” (a large group of policyholders is in a poor position to negotiate with the insurer the level of risk of insolvency the policyholders will tolerate for any given premium level).<sup>13</sup> Solvency regulation can, in principle, address this issue by requiring management to hold enough capital to reduce the risk of insolvency to the point to which the policyholders would reduce it if they were capable of effectively representing their interests.<sup>14</sup>

The point might also be phrased in historical terms: Unregulated insurers apparently have shown a tendency to go bust and disappoint policyholders, suggesting that unregulated markets don’t function optimally. No matter how the justification is phrased, solvency regulation historically has been based on consumer protection, broadly construed.<sup>15</sup>

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<sup>11</sup> See Grace & Klein, *The Future of Insurance Regulation*, *supra* note 34, at 26

<sup>12</sup> See *id.* at 27; GUILLAME PLANTIN & JEAN CHARLES ROCHET, WHEN INSURERS GO BUST, 42, That in turn means that the managers of firms that are getting into trouble have a window of opportunity to employ risky strategies to try to return to survival, even though these strategies have a high probability of imposing large losses on policyholders by increasing the consequences of insolvency. *Id.* at 44-45. Shareholders would not be expected to police such behavior because they have no incentive to care about how much the policyholders receive if the shareholders are wiped out. *Id.* at 56.

<sup>13</sup> See Grace & Klein, *supra* note 34, at 26; PLANTIN & ROCHET, *supra* note 124, at 57.

<sup>14</sup> Economists (and regulators) stress that the goal of solvency regulation is not to reduce defaults to zero. See, e.g., Grace & Klein, *The Future of Insurance Regulation*, *supra* note 34, at 28 (goal is to “minimize the social cost of defaults”).

<sup>15</sup> See, e.g., Patricia Munch & Dennis E. Smallwood, *Solvency Regulation in the Property-Liability Insurance Industry: Empirical Evidence*, 11 BELL. J. ECON. 261, 261 (1980) (“The rationale for solvency regulation is to protect the interests of policyholders, third-party liability claimants and other firms (to whom the obligations of an insolvent firm are shifted by guaranty fund arrangements).”). The recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act can be seen as affirming this. The Act does recognize the possibility that an insurer, together with its affiliates, could become systemically significant and thus suitable for regulation as a “nonbank financial company supervised by the Board of Governors,” see 31 U.S.C. § 313(c)(1)(C) (added by § 502 of Dodd-Frank), but



Indeed, an industry representative recently testified to Congress that solvency is “the most important consumer protection of all.”<sup>16</sup>

Historically, the justification for insurance solvency regulation has *not* been that insurers’ activities create “systemic risk,” a term that has no universally accepted meaning but that will be defined broadly here as the imposition of significant costs on actors that are not owners or creditors of the firm via effects of insolvency on the financial system as a whole. Insurance companies have not been seen as posing systemic risk the way that banks (or investment banks in the “shadow banking” system) have done.<sup>17</sup> The financial crisis has changed this perception to some extent, as discussed in Part III, below.

Despite its venerable age, solvency regulation has been criticized. Some authors conclude that if consumers are fully informed of the risk of insolvency, then insurers will retain sufficient capital. This suggests that disclosure rather than a prescriptive capital requirement is the appropriate policy.<sup>18</sup> It is also argued that regulatory costs fall heavily on smaller,

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it shows great solicitude for the importance of consumer protection. One of the main purposes of the Act’s insurance-related provisions is to authorize the negotiation of international agreements regarding prudential measures with respect to the business of insurance, *id.* § 314(a), and it limits the agreements it covers to those that achieve “a level of protection for insurance or reinsurance consumers that is substantially equivalent to the level of protection achieved under State insurance or reinsurance regulation.” *Id.* § 313(r)(2)(B).

<sup>16</sup> *Regulatory Restructuring: Enhancing Consumer Financial Products Regulation: Hearing Before the H. Comm. on Financial Services*, 111th Cong. 55-57 (2009) (statement of Gary E. Hughes, Executive Vice President. & General Counsel, American Council of Life Insurers).

<sup>17</sup> See, e.g., MARKUS BRUNNERMEIER, ET AL., *THE FUNDAMENTAL PRINCIPLES OF FINANCIAL REGULATION* 26 (2009) (classifying insurance companies as “non-systemic large” entities that “need full micro-prudential regulation, but no additional macro-prudential regulation.”); Schwarcz, *supra* note 109, at 1736; Richard Herring & Til Schuermann, *Capital Regulation for Position Risk in Banks, Securities Firms, and Insurance Companies*, in *CAPITAL ADEQUACY BEYOND BASEL: BANKING, SECURITIES, AND INSURANCE* 15, 23 (Hal S. Scott ed. 2005) (“[T]here has been no evidence of the failure of an insurance company being a significant source of systemic risk.”); Scott E. Harrington, *Capital Adequacy in Insurance and Reinsurance*, in *CAPITAL ADEQUACY BEYOND BASEL*, *supra*, 87, 92 (Hal S. Scott ed. 2005) (“It generally is agreed that systemic risk is relatively low in insurance markets compared with banking, especially for nonlife insurance.”); JONATHAN R. MACEY ET AL., *BANKING LAW AND REGULATION* 112-14 (3d ed. 2001).

<sup>18</sup> See Ray Rees et al., *Regulation of Insurance Markets*, 24 *GENEVA PAPERS*

specialized insurers<sup>19</sup> and that any reduction in insolvencies due to regulation arises from the fact that these costs reduce the number of small firms in the market. Still other authors criticize the specific measures of insolvency risk that U.S. regulators have adopted.<sup>20</sup> While these criticisms are interesting and provocative, evaluating them is beyond the scope of this Article. The Article proceeds on the assumption that it is unlikely that the immediately foreseeable future will bring a revision of the consensus view among policymakers that solvency regulation of insurance is appropriate.

C. THE INSTITUTIONAL SETTING OF SOLVENCY REGULATION:  
STATES AND THE NAIC

Insurance in the United States historically has been and currently is regulated at the state level.<sup>21</sup> Generally, state insurance regulators are

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ON RISK AND INS. THEORY 55, 56, 67 (1999); *see also* Eling & Holzmüller, *supra* note 98, at 32. The Geneva Papers on Risk and Insurance are published by The Geneva Association, which describes itself as the “leading international ‘think tank’ of the insurance industry.” The Geneva Association, [http://www.genevaassociation.org/About\\_Us/Introduction.aspx](http://www.genevaassociation.org/About_Us/Introduction.aspx), (last visited Oct. 14, 2010).

<sup>19</sup> Anton van Rossum, *Regulation and Insurance Economics*, 30(1) GENEVA PAPERS ON RISK AND INS. 43 (2005). One older study of capital requirements, which apparently examined the effect only of fixed, absolute capital levels, generated results that the authors interpreted as supporting the proposition that “[m]inimum capital requirements appear to reduce insolvencies by reducing the number of small, domestic firms.” Munch & Smallwood, *supra* note 154, at 261.

<sup>20</sup> *See, e.g.*, Steven W. Pottier & David W. Sommer, *The Effectiveness of Public and Private Sector Summary Risk Measures in Predicting Insurer Insolvencies*, 21 J. FIN. SERV. RES. 101, 114 (2002) (finding the NAIC’s risk-based capital ratios and financial analysis solvency tools (FAST) to be worse at predicting insolvency than capital adequacy ratios and ratings produced by the private credit rating agency A.M. Best, which specializes in insurance).

<sup>21</sup> In *Paul v. Virginia*, 75 U.S. 168, 183, (1868), decided shortly after the birth of state-level insurance regulation, the Supreme Court decided that the federal government lacked authority to regulate insurance. The Court reversed its position in *United States v. South-Eastern Underwriters Ass’n*, 322 U.S. 533, 553 (1944). In 1945, Congress adopted the McCarran-Ferguson Act, which affirmed the primacy of state regulation by declaring “the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States.” 15 U.S.C. § 1011. *See* Susan Randall, *Insurance Regulation in the United States: Regulatory*

given authority over insurers' ability to incorporate or conduct business in the state in question, and are charged with enforcing requirements created by state statutes, which typically include minimum capital levels.<sup>22</sup> Primary responsibility for insurer capital regulation is delegated to the state in which the insurer is domiciled, with nondomiciliary states typically staying their hands unless the domiciliary state is falling down on the job.<sup>23</sup> It is said that state insurance regulators in the United States typically discharge their responsibilities via a rules-based, rather than a principles-based, approach.<sup>24</sup>

The Dodd-Frank Act does not expressly change the federal-state balance of power. Although the Act creates a new Federal Insurance Office within the Department of the Treasury,<sup>25</sup> it expressly provides that nothing in the provisions establishing and granting authority to the Office "shall be construed to establish or provide the Office or the Department of the Treasury with general supervisory or regulatory authority over the business of insurance."<sup>26</sup> The Act does contemplate international harmonization of prudential standards via bilateral or multilateral agreements,<sup>27</sup> but specifically saves state capital and solvency standards from being preempted by such agreements (or otherwise) unless the state standards discriminate against non-U.S. insurers.<sup>28</sup> In other words, it

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*Federalism and the National Association of Insurance Commissioners*, 26 FLA. ST. U. L. REV. 625, 629-34 (1999), for an account of these events.

<sup>22</sup> Grace & Klein, *supra* note 34, at 38.

<sup>23</sup> *Id.* at 39.

<sup>24</sup> *Id.* at 38.

<sup>25</sup> The Dodd-Frank Act adds new sections 313 and 314 to Title 31 of the U.S. Code. See H.R. 4173. Dodd-Frank Wall Street Reform and Consumer Protection Act § 1, 31 U.S.C. § 313-14. Section 313(a) establishes the Federal Insurance Office within the Department of the Treasury, 31 U.S.C. § 313(a), authorizes the Office to monitor the insurance industry and advise the Financial Stability Oversight Council, *id.* § 313(c)(1)(A), (c)(1)(C), (c)(3), and directs the Office to report annually to Congress on the industry, *id.* § 313(n).

<sup>26</sup> *Id.* § 313(k).

<sup>27</sup> See *id.* § 314(a) (authorizing the Secretary of the Treasury and the U.S. Trade Representative to negotiate "covered agreements"); *id.* § 313(r)(2) (defining a "covered agreement" as "a written bilateral or multilateral agreement regarding prudential measures with respect to the business of insurance or reinsurance that" is international and "relates to the recognition of prudential measures with respect to the business of insurance or reinsurance that achieves a level of protection for insurance or reinsurance consumers that is substantially equivalent to the level of protection achieved under State insurance or reinsurance regulation.").

<sup>28</sup> See *id.* § 313(j)(1)(D) (as added by Dodd-Frank) (no preemption of "any

appears that a state may maintain whatever capital and solvency regime is in place as long as the state treats non-U.S. insurers subject to international solvency agreements the same as it treats insurers domiciled in the state.

Although the state legislatures and insurance regulators have the final say in most areas of insurance regulation, that does not mean that there are 50 different, independent versions of each regulatory requirement. States coordinate their regulatory efforts – at least to some extent – through the National Association of Insurance Commissioners (NAIC), a voluntary association of the insurance commissioners of the 50 states, the District of Columbia, and the U.S. territories.<sup>29</sup> The NAIC has had an important role in proposing uniform rules and standards ever since its formation in 1871.<sup>30</sup> In general, the history of the NAIC reflects the tension between state regulators' desire to preserve a state-centric regulatory system and the desire to minimize unnecessary contradiction and duplication in regulating an increasingly national and international industry.<sup>31</sup>

One result of this ongoing tension is a regulatory system that is more uniform in some areas than in others. Solvency regulation is an area where substantive standards are “relatively uniform,”<sup>32</sup> largely because state insurance regulators use the risk-based capital framework that the NAIC has developed.<sup>33</sup> Although the state of domicile has primary regulatory responsibility for the financial condition of any given insurer, the use of a common capital regulation framework reduces state-by-state variation in how that responsibility is carried out. One important solvency-related area in which the NAIC's efforts have not brought about uniformity is in state investment laws, as discussed in Part II.B, below.

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State insurance measure covering the capital or solvency of an insurer, except to the extent that such State insurance measure results in less favorable treatment of a non-U.S. insurer than a U.S. insurer.”); *see also id.* § 313(f)(1) (state insurance measures preempted only if Director determines that measure results in less favorable treatment of a non-U.S. insurer “domiciled in a foreign jurisdiction that is subject to a covered agreement” than a U.S. insurer admitted in the state *and* “is inconsistent with a covered agreement.”).

<sup>29</sup> Randall, *supra* note 219, at 629.

<sup>30</sup> *Randall, supra note 201d*, at 631-32; *see also* Paul Walker-Bright, *Reed Smith LLP on the Potential for Future Regulation of Insurance in Light of AIG, Inc.'s Financial Collapse*, 2008 LEXISNEXIS EMERGING ISSUES 3091..

<sup>31</sup> *See generally* Randall, *supra* note 2021, at 634-40.

<sup>32</sup> Grace & Klein, *supra* note 43, at 2.

<sup>33</sup> Therese M. Vaughan, *The Economic Crisis and Lessons from (and for) U.S. Insurance Regulation*, 9 (unpublished working paper) (on-file with NAIC Journal of Insurance Regulation).

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The NAIC is involved not just in setting standards for insurance companies, but also in oversight of the insurers' operations. The NAIC's Financial Analysis Division carries out ongoing oversight of all "nationally significant insurers" and reports unusual findings to a college of regulators, the Financial Analysis Working Group.<sup>34</sup> The Working Group, which has 16 members who have been described as among "the most experienced financial regulators in the system of U.S. insurance regulation," reviews companies that have been identified by the Financial Analysis Division and discusses such companies' status with the primary regulator.<sup>35</sup> It is said that the NAIC uses this process to address problems created by some states which tend to be lax in regulating their home insurers. NAIC's coordination of solvency oversight can help nudge the domiciliary state to move if it is not being stringent enough.<sup>36</sup>

Since 1990, the NAIC has attempted to promote a minimum level of regulatory effectiveness in all states by running an accreditation program. A NAIC accreditation team reviews each state's laws, regulations, and operations every five years, and makes suggestions along with recommendations to the other states, who decide whether the state's accreditation should be continued.<sup>37</sup> It appears that all 50 states and the District of Columbia are now accredited under this program.<sup>38</sup>

### III. CREDIT RATINGS IN U.S. INSURANCE REGULATION

As an NAIC working group recently concluded, "[r]atings are used extensively in insurance regulation," and such reliance is "often required by statute."<sup>39</sup> This Part surveys the current role of credit ratings in U.S.

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<sup>34</sup> *Id.* at 10.

<sup>35</sup> *Id.*

<sup>36</sup> Grace & Klein, *supra* note 43, at 39.

<sup>37</sup> Vaughan, *supra* note 33, at 11; Grace & Klein, *supra* note 34, at 39 (in addition to state-level financial monitoring, NAIC reviews insurer financial reports for larger companies that write business in a significant number of states).

<sup>38</sup> See VAUGHAN & VAUGHAN, *supra* note 42, at 109 (as of 2007, all states but New York were accredited); Press Release, New York State Ins. Dep't, Sept. 22, 2009 (announcing accreditation of New York), available at <http://www.ins.state.ny.us/press/2009/p0909221.htm>. The fact that New York, which historically has been viewed as one of the most sophisticated state regulators, was unaccredited for so long has been interpreted by some as evidence of deficiencies in the accreditation program itself. See Randall, *supra* note 20, at 663-64.

<sup>39</sup> NAIC RATING AGENCY WORKING GROUP, EVALUATING THE RISKS

insurance regulation.

A. CREDIT RISK, CREDIT RATINGS, AND CAPITAL REQUIREMENTS

Insurers face both fixed and risk-based capital requirements. Each state has a fixed capital requirement for insurers; the requirements range from \$500,000 to \$6 million.<sup>40</sup> These numbers suggest that the fixed-capital requirements are significant only for the smallest insurance companies.

The more important capital requirements are the risk-based capital requirements that follow the NAIC framework introduced in the 1990s.<sup>41</sup> The system, which is designed to force insurers that take greater risks to hold more capital, is composed of two elements:<sup>42</sup> The first is a risk-based capital formula, which establishes the minimum capital level, and the second is a model law that authorizes the state insurance regulator to take specific action when an insurer's capital falls below prescribed levels.<sup>43</sup> Under current NAIC rules, credit ratings determine the amount of capital insurers must hold.

1. Overview of the Risk-Based Capital Framework

In general outline, an insurer's risk-based capital (RBC) requirement is computed by (1) attempting to quantify "risk charges" and various risks the company faces; and (2) combining the resulting risk charges for the individual risks into a total capital requirement in a way that very roughly takes into account whether the risks are correlated or independent.

Different RBC formulas are used for different types of insurers – life, property and casualty, and health -- reflecting differences in the risks the insurers face. A life insurance company's risk-based capital is used as

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ASSOCIATED WITH NAIC RELIANCE ON NRSRO CREDIT RATINGS – FINAL REPORT OF THE RAWG TO THE FINANCIAL CONDITIONS COMMITTEE, 2 (2010) [hereinafter RAWG FINAL REPORT].

<sup>40</sup> Eling & Holzmüller, *supra* note 89, at 34.

<sup>41</sup> See VAUGHAN & VAUGHAN, *supra* note 42, at 107 (RBC standards for life insurers introduced in 1992, for property and liability insurers in 1993, and for health insurers in 1997).

<sup>42</sup> National Association of Insurance Commissioners, *Risk-Based Capital General Overview* (July 15, 2009), [http://www.naic.org/documents/committees\\_e\\_capad\\_RBCoverview.pdf](http://www.naic.org/documents/committees_e_capad_RBCoverview.pdf).

<sup>43</sup> NAIC MODEL LAWS, REGULATIONS, AND GUIDELINES 312-1, (2007)

an example.<sup>44</sup>

Consider four risks that a life insurance company faces:<sup>45</sup> the risk of subsidiaries' loss due to defaults on their investments (affiliate risk), credit risk on the insurer's investments, interest rate risk, and insurance risk (the risk of greater-than-expected losses because of a need to pay out on policies). The losses are combined as follows:<sup>46</sup>

$$\text{Affiliate Risk} + \sqrt{(\text{Credit Risk} + \text{Rate Risk})^2 + \text{Insurance Risk}^2}$$

As the example shows, some risks are added directly and some are added in squares. This reflects an implicit decision to model the risks that are directly added as perfectly correlated, and those that are added in squares as independent.<sup>47</sup> The example therefore illustrates a determination that credit risk and rate risk are perfectly correlated with one another and independent of insurance risk. The risk arising from the combination of credit risk, rate risk, and insurance risk is considered perfectly correlated with affiliate risk. Insurance regulators have been taken to task over the years for this crude treatment of the correlation of risk.<sup>48</sup>

Most risk charges are quantified by applying factors to items on the balance sheet.<sup>49</sup> For example, according to a document on the Society of Actuaries website, insurance risk in the example above is equal to total life insurance in force, less reserves (which cover the expected loss from policy payouts), multiplied by a factor determined by regulators.<sup>50</sup> Computation

<sup>44</sup> National Association of Insurance Commissioners, *supra* note 42, at 2.

<sup>45</sup> The risk-based capital formula takes account of other risks, *see id.* at 4, but they are omitted for ease of exposition.

<sup>46</sup> *Id.* at 4; Craig F. Likkel & Lloyd M. Spencer, Jr., 2004 Valuation Actuary Symposium Boston, Session 14 PD: Risk-Based Capital (2004), [http://www.soa.org/files/pdf/14\\_combo-valact04.pdf](http://www.soa.org/files/pdf/14_combo-valact04.pdf).

<sup>47</sup> *See* PLANTIN & ROCHET, *supra* note 12, at 34-37.

<sup>48</sup> *See, e.g.,* Lawrence J. White, *The NAIC Model Investment Law: A Missed Opportunity*, in *THE STRATEGIC DYNAMICS OF THE INSURANCE INDUSTRY: ASSET/LIABILITY MANAGEMENT ISSUES* 41, 41 (Edward I. Altman & Irwin T. Vanderhoof, eds. 1996).

<sup>49</sup> Nancy Bennett, Panel Discussion, *Use of Rating Agency Ratings in State Insurance Regulation*, RATING AGENCY (E) WORKING GROUP HEARING, Sept. 24, 2009, [http://www.naic.org/committees\\_e\\_rating\\_agency\\_090924\\_hearing\\_panel1.htm](http://www.naic.org/committees_e_rating_agency_090924_hearing_panel1.htm).

<sup>50</sup> Fred Tavan, Society of Actuaries, *Risk-Based Capital*, (Feb 28, 2007), <http://www.soa.org/files/pdf/03-RMTF-RiskBasedCap.pdf>. According to the cited document, the factor is 0.1495% for the first \$500 million in risk and 0.0975% for

of the risk charge for the credit risk of insurer investments is described in detail in Part III, below.

2. Regulatory Action Under the Risk-Based Capital Framework

The second major component of the risk-based capital framework is a risk-based capital model law that authorizes the state insurance authorities to take action when the insurer’s capital falls short of prescribed levels.<sup>51</sup> Whether capital is impaired depends on a comparison of the company’s actual capital<sup>52</sup> to the minimum required risk-based capital derived from the formula discussed above. Conceptually, the insurer’s capital is equal to assets minus liabilities; the rules elaborate on this concept in more detail.<sup>53</sup>

The minimum risk based capital is also called the “authorized control level,” and regulatory actions are keyed to actual capital as a percentage of authorized control level.

Table 1: Regulatory Actions Under NAIC Model Act 312<sup>54</sup>

Percentage	of	Regulatory Action
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amounts above \$500 million.

<sup>51</sup> National Association of Insurance Commissioners, *supra* note 424, at 1., There are two NAIC model laws; one that covers property-casualty insurers and life insurers, and one that applies to health insurance companies. *Id.*

<sup>52</sup> Grace & Klein, *supra* note 43, at 39; Eling & Holzmüller, *supra* note 89, at 35 (insurer’s “total available capital” is its “statutory capital and surplus”).

<sup>53</sup> For life insurance companies, total adjusted capital is equal to unassigned surplus plus asset valuation reserve plus half of dividend liability. Bennett, *supra* note 498. The “asset valuation reserve” is an amount deducted from the total assets to reflect risks, including default risk. *Id.* “Surplus” is assets minus liabilities, and the “asset valuation reserve” is “assigned surplus.” *Id.*

<sup>54</sup> See National Association of Insurance Commissioners, *supra* note 424, at 4-5.



Authorized Control Level	
>200%	No action.
150-200%	Company Action Level: Insurer must report to regulator on what contributed to the company's condition. Insurer's plan must contain proposals to correct the problems and provide projections of financial condition, both with and without the corrections, identifying assumptions underlying the projections and problems with the insurer's business.
100-150%	Regulatory Action Level: Insurer must file an action plan, and state insurance commissioner must perform any examinations or analyses of the insurer's business and operations that he or she deems necessary, and must issue appropriate corrective orders.
70-100%	Authorized Control Level: Regulator is <u>authorized</u> to take control of the insurer.
<70%	Mandatory Control Level: Regulator is <u>required</u> to take steps to place the insurer under control

### 3. Use of Credit Ratings in Assessing Credit Risk

Insurers of every type are subject to capital charges for credit risk.<sup>55</sup> The capital charge for a given fixed-income investment, such as a bond, note, or mortgage-backed security, is determined by multiplying the book value of the investment<sup>56</sup> by a "quality coefficient" designed to measure the investment's riskiness.<sup>57</sup> Quality coefficients are based on the investment's classification into one of six categories, NAIC-1 to NAIC-6, with NAIC-1 corresponding to the lowest credit risk and NAIC-6 the highest.

The default rule has been that insurers must file fixed-income

<sup>55</sup> See *id.* at 2. ("asset risk – other" is a capital charge for all insurer types); Bennett, *supra* note 498, at 7 ("asset risk – other" include the risk of investment defaults).

<sup>56</sup> Investments are carried at acquisition price unless "impaired" (meaning that the company does not anticipate that the instrument will perform as agreed). Impaired instruments are carried at market value. Bennett, *supra* note 498, at 8.

<sup>57</sup> Eling & Holzmüller, *supra* note 98, at 34.

securities they own with the Securities Valuation Office (“SVO”) of the NAIC, which assigns each security to one of the six categories and charges the insurer for this service. In 2004, however, the NAIC exempted from this requirement securities with ratings from recognized rating agencies, as discussed in more detail in Part IV.A.1 below.<sup>58</sup>

The NAIC rating of a rated security is determined by its agency rating, according to fixed mapping between the two schemes, set out below. If the security is rated by just one agency, that agency’s rating is used.<sup>59</sup> If the security is rated by two agencies, the lower of the two ratings is used,<sup>60</sup> If the security is rated by more than two agencies, the security’s second-lowest rating is used.<sup>61</sup>

The upshot is that if a recognized rating agency chooses to issue a rating on a debt instrument, the capital charge is based on the agency’s rating.

Table 2: NAIC Classifications and Agency Ratings<sup>62</sup>

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<sup>58</sup> National Association of Insurance Commissioners, *Understanding the NAIC Filing Exemption (FE) Rule 1*, (Feb. 25, 2004), [http://www.naic.org/documents/svo\\_FE\\_FAQ.pdf](http://www.naic.org/documents/svo_FE_FAQ.pdf). The NAIC maintains a list of “approved rating organizations” (AROs) whose ratings count for regulatory purposes. The SEC also maintains a list of “nationally recognized statistical rating organizations” (NRSROs), which is probably more widely known. The NAIC’s AROs appear to be a subset of the SEC’s NRSROs. rating agencies that the SEC has designated “nationally recognized statistical rating organizations” (NRSROs). Compare NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS, PURPOSES AND PROCEDURES MANUAL OF THE NAIC SECURITIES VALUATION OFFICE 36 (Dec. 31, 2009) (NAIC list of six approved rating organizations) with SECURITIES AND EXCHANGE COMMISSION, ANNUAL REPORT ON NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS 3-4 (Jan. 2011) (SEC list of ten NRSROs).

<sup>59</sup> See National Association of Insurance Commissioners, *Request for Proposal Pertaining to Residential Mortgage-Backed Securities Owned by U.S.-Domiciled Companies*, 12 (Oct. 23, 2009) [http://www.naic.org/documents/svo\\_rmbs\\_rfp\\_102309.pdf](http://www.naic.org/documents/svo_rmbs_rfp_102309.pdf).

<sup>60</sup> See *id.*

<sup>61</sup> See *id.*

<sup>62</sup> Sholom Feldblum, *NAIC Property/Casualty Insurance Company Risk-Based Capital Requirements*, 83 PROCS. CAS. ACTUARIAL SOC’Y, 297, 304-05 (1996); Chris Evangel, Panel Discussion, *Use of Rating Agency Ratings in State Insurance Regulation* RATING AGENCY (E) WORKING GROUP HEARING, (Sept. 24, 2009) [http://www.naic.org/committees\\_e\\_rating\\_090924\\_hearing\\_panel1.htm](http://www.naic.org/committees_e_rating_090924_hearing_panel1.htm).

NAIC Class	Bond Factor	RBC Preferred Stock RBC Factor	Agency Rating Equivalent
Federal Government Bonds	0.0%	NA	
1: Highest Quality	0.3%	2.3%	AAA to A-
2: High Quality	1.0%	3.0%	BBB+ to BBB-
3: Medium Quality	2.0%	4.0%	BB+ to BB-
4: Low Quality	4.5%	6.5%	B+ to B-
5: Lower Quality	10.0%	12.0%	CCC+ to CCC-
6: In or Near Default	30.0%	30.0%	CC+ to D

#### B. RATING DEPENDENCE AND INVESTMENT LAWS

All states have laws that directly govern the types of investments insurers can make. Unlike capital requirements, which require only that insurers maintain a larger financial cushion for riskier investments, state investment laws directly govern investment – for example by authorizing only certain types of investments and forbidding all others, or by requiring that only a certain percentage of investments fall below a credit-rating threshold. State investment laws are also unlike capital requirements in that they are quite heterogeneous. As described below, different states impose very different requirements, despite an effort at NAIC to standardize these rules.

State requirements of the form “X investment is prohibited absent a rating higher than Y” are relatively uncommon, although they do exist, as described below. Ratings also come into play in some states in determining whether insurers have excessive exposure to risky assets or excessively concentrated portfolios. In aggregate, state investment laws give significance to a rating agency’s decision to issue a rating – particularly a high one.

##### 1. NAIC’s Model Investment Laws

In 1991, the NAIC created a working group to devise a model law

governing all insurer investments.<sup>63</sup> Over the course of several years, the working group developed a proposal that was based on enumerating the specific types of assets an insurer could hold. This proposal ultimately became the Investments of Insurers Model Act (Defined Limits Version),<sup>64</sup> adopted by NAIC in 1996.<sup>65</sup> According to NAIC staff annotations, this version of the Model Act has been adopted in seven states and the District of Columbia.<sup>66</sup> According to contemporary accounts, insurers strongly resisted the Defined Limits Version, preferring a more open-ended investment law that did not enumerate permissible investments in detail, but instead permitted any investment that met a general standard of prudence.<sup>67</sup> This idea became the basis of the Investments of Insurers Model Act (Defined Standards Version),<sup>68</sup> adopted by NAIC in 1997.<sup>69</sup> The NAIC staff annotations indicate that Georgia, Missouri, and South Dakota acted in some respect on the Defined Standards Version of the

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<sup>63</sup> See HOWELL E. JACKSON & EDWARD L. SYMONS, JR., REGULATION OF FINANCIAL INSTITUTIONS 446 (1999).

<sup>64</sup> NAIC MODEL LAWS, REGULATIONS, AND GUIDELINES 280-1, §§ 1-32 (1996) [*hereinafter* Model Investment Act (Defined Limits Version)].

<sup>65</sup> *Id.* § 32.

<sup>66</sup> *Id.* § State Adoption. According to the NAIC staff, the Defined Limits Version of the Model Investment Act has been adopted in Alaska, the District of Columbia, Illinois, Kentucky, Montana, New Jersey, South Carolina, and West Virginia.

<sup>67</sup> See Robert M. Ferm & Jon M. Moellenberg, *Recent Developments in the Public Regulation of Insurance Law*, 31 TORT & INS. L.J. 447, 460 (1996); Noreen J. Parrett & Steven M. Schindhelm, *Recent Developments in the Public Regulation of Insurance Law*, 32 TORT & INS. L.J. 553, 564-65 (1997); Mark R. Goodman, *Recent Developments in the Public Regulation of Insurance Law*, 33 TORT & INS. L.J. 681, 691 (1998).

<sup>68</sup> NAIC MODEL LAWS, REGULATIONS, AND GUIDELINES 283-1, §§ 1-19 [*hereinafter* Model Investment Act (Defined Standards Version)]. Section 4.B sets out the prudency standard in familiar language, providing that the board of directors “shall exercise the judgment and care, under the circumstances then prevailing, that persons of reasonable prudence, discretion, and intelligence exercise in the management of a like enterprise, not in regard to speculating but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital.” *Id.* at § 4.B. In keeping with the general push to take diversification into account in financial regulation, the Defined Standards Version expressly directs insurer boards of directors in Section 5.E to “consider ... [t]he extent of the diversification of the insurer’s investments.” *Id.* at § 5.E.

<sup>69</sup> *Id.* at § 19.

Model Investment Act.<sup>70</sup>

The Defined Limits Version of the Act relies heavily on the NAIC's six-tier classification system to define permitted investments. It provides that insurers generally may hold only "rated" credit instruments,<sup>71</sup> and restricts an insurer's holdings of "medium and lower grade investments" to specified fractions of the insurer's total admitted assets.<sup>72</sup> "Medium and lower grade investments" are defined in terms of credit ratings.<sup>73</sup>

The Defined Limits Version provides that property and casualty insurers may invest in investment pools that in turn invest only in obligations with NAIC-1 or NAIC-2 ratings, money market funds, or securities lending or repurchase transactions.<sup>74</sup>

<sup>70</sup> *Id.* at § State Adoption.

<sup>71</sup> See Model Investment Act (Defined Limits Version) § 3.A ("Investments not conforming to this Act shall not be admitted investments"); *id.* at § 11 (subject to certain limitations, life and health insurers "may acquire rated credit instruments"); *id.* §§ 21, 24 (subject to certain limitations, property and casualty, financial guaranty, and mortgage guaranty insurers "may acquire rated credit instruments"). In turn, a "rated credit instrument" is defined as a credit instrument that meets one of the following tests: (1) "rated or required to be rated by the SVO"; (2) has a maturity of 397 days or less, and issued by an entity that is rated by the SVO or an NRSRO recognized by the SVO; (3) has a maturity of 90 days or less and is issued by an adequately capitalized bank; (4) is a share of a money market mutual fund; or (5) is a share of a class one bond mutual fund. See *id.* §§ RRR. Notably, the last two categories are implicitly rating-dependent. Money-market funds are required to invest in instruments that have high NRSRO ratings or the equivalent. 17 C.F.R. § 270.2a-7(c)(3)(i), (a)(10). SEC Investment Company Act Rule 2a-7. Class one bond mutual funds are required to "maintain the highest credit quality rating given by an NAIC ARO." NAIC PRACS. & PROCS. MAN., Part 6, § 2(b)(iii), at 201 (2009).

<sup>72</sup> Model Investment Act (Defined Limits Version) §§ 10 (life and health insurers), 23 (property, casualty, and financial and mortgage guaranty insurers). NAIC-6 securities may make up only 1% of admitted assets; NAIC-5 and -6 securities together may make up only 3% of assets; "lower grade investments" may make up only 10% of assets, and "medium and lower grade investments" may make up only 20% of assets. *Id.*

<sup>73</sup> *Id.* § 1.BBB (stating that "Medium grade investments" are those rated NAIC-3); *id.* § 1.Z (stating that "Lower grade investments" are those rated NAIC-4, -5, and -6).

<sup>74</sup> *Id.* § 25.A. Recall that money-market funds themselves are required to invest only in instruments carrying certain ratings. 17 C.F.R. § 270.2a-7(a)(12)(i), (c)(3)

Although the Model Investment Act itself has not been widely adopted (in either version), it appears that every state has a law governing insurance-company investments.<sup>75</sup>

## 2. Rating Dependence in State Insurance Investment Laws

Apart from the jurisdictions that have adopted the Model Investment Act (Defined Limits Version) – Alaska, the District of Columbia, Illinois,<sup>76</sup> Kentucky, Montana, New Jersey,<sup>77</sup> and West Virginia – a number of other states’ investment laws rely expressly on ratings.

This section presents the results of a survey of investment laws of several states that are particularly important to insurance regulation, specifically California, Connecticut, Massachusetts, Minnesota, New Jersey, and New York.<sup>78</sup> The purpose of the survey was to determine the extent of rating-dependent regulation in each state. Most state investment laws enumerate specified permitted types of investments and forbid all others, although some allow any “prudent” investments. Laws of the former type frequently include rating-based criteria for permitted investments. In addition, credit ratings are used to specify permitted investment-pool investments, aggregate exposure limits, and derivative counterparty exposures.

### *a. Direct Authorization*

#### *i. Corporate Debt*

Most states do not impose direct rating requirements for

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<sup>75</sup> *Id.* § State Adoption (indicating that every state has “related state activity” for the Model Investment Act).

<sup>76</sup> Illinois is the domicile of major insurance subsidiaries of Allstate, and is the site of the corporate headquarters of State Farm.

<sup>77</sup> It appears that New Jersey has adopted the Model Investment Act only in part. Its provisions are discussed in more detail in the text. Prudential Insurance is domiciled in New Jersey and its principal regulatory authority is the New Jersey Department of Banking and Insurance.

<sup>78</sup> The list of states was developed by reviewing the reports of the ten largest insurance groups in the United States and determining the principal regulator of each group’s major insurance subsidiaries. This list was supplemented by consulting with other academics to identify states that generally are considered important insurance regulators.

investments in corporate bonds, although there are some exceptions. One important exception is New York, whose investment laws for most non-life insurers<sup>79</sup> (including financial guaranty insurers) define permitted U.S. investments by credit rating, although the rules for life insurers generally do not.<sup>80</sup>

Minnesota's general law for life insurers<sup>81</sup> provides that investments in preferred stock<sup>82</sup> and corporate bonds,<sup>83</sup> must meet minimum rating requirements. Certain large, well-capitalized life insurers are subject to a different requirement.

## *ii. Mortgage-Backed Securities*

Mortgage-backed securities are an important exception to the general rules that states regulate the instruments in which insurers are permitted to invest. The Secondary Mortgage Market Enhancement Act ("SMMEA"),<sup>84</sup> enacted in 1984, has required state regulators to treat mortgage-backed securities that receive high credit ratings<sup>85</sup> as the

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<sup>79</sup> The provision discussed applies to insurers other than life insurers, nonprofit medical/dental insurers, title insurers, and domestic charitable annuity societies. N.Y. INS. LAW §§ 1403(a), (c) (McKinney 2006).

<sup>80</sup> N.Y. INS. LAW § 1404(a)(2) (McKinney 2006) (permitting investment in obligations of U.S. institutions that are secured or that are "rated A or higher by a securities rating agency recognized by the superintendent" or insured by an insurer "with a Aaa rating from a securities rating agency recognized by the superintendent" or that "have been given the highest quality designation by the Securities Valuation Office of the National Association of Insurance Commissioners."). The rules for acquiring interests in loans secured by real estate, apparently including mortgage-backed securities, are not rating-dependent. *Id.* § 1404(a)(4). The statute does not clearly authorize purchases of ABS.

<sup>81</sup> Minnesota is the domiciliary state for major insurance subsidiaries of The Travelers Group.

<sup>82</sup> MINN. STAT. ANN. § 61A.28, subdiv. 6(b)(3) (West 2005) (forbidding investments in preferred stock "rated in the four lowest categories" established by the SVO).

<sup>83</sup> *Id.* subdiv. 6(e)(2) (West 2005)(permitting investments in bonds, obligations, and notes that are rated in the four highest categories by at least one NRSRO, or in one of the two highest categories by SVO). *Id.* subdiv. 6(f) (Non-investment grade obligations must meet an earnings test to be eligible for investment).

<sup>84</sup> PUB. L. 98-440, effective Oct. 3, 1984.

<sup>85</sup> 15 U.S.C. § 78c(1)(41).

equivalent of U.S. government obligations.<sup>86</sup> Because insurers are universally permitted to invest in U.S. government obligations, SMMEA has effectively required states to permit insurers to invest in high-rated mortgage-backed securities. Dodd-Frank repeals the provision of SMMEA that tied the preferential treatment of MBS to high credit ratings,<sup>87</sup> but the repeal does not go into effect until July 2012.<sup>88</sup>

SMMEA did provide for a seven-year period in which states could affirmatively opt out of its requirement that high-rated MBS be treated the same as Treasury bonds.<sup>89</sup> It appears that ten states opted out of SMMEA's preemption provisions for insurance,<sup>90</sup> including two states that are major insurance regulators, Connecticut<sup>91</sup> and New York.<sup>92</sup>

Even states that did not opt out of SMMEA do have rules permitting insurer investment in specified mortgage-backed securities. These rules do not refer to ratings, and instead depend on characteristics of the mortgages themselves, such as loan priority, loan-to-value ratio, whether the mortgages are covered by mortgage insurance, and the amortization period of the loans.<sup>93</sup> In light of SMMEA's requirement that insurers be permitted to invest in high-rated mortgage-backed securities, it seems that these statutes expand the category of mortgage-backed securities in which insurers can invest.

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<sup>86</sup> 15 U.S.C. §77r-1(a)(1)

<sup>87</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, PUB. L. 111-203, July 21, 2010. § 939(e).

<sup>88</sup> *Id.* §939(g).

<sup>89</sup> 15 U.S.C. § 77r-1(b).

<sup>90</sup> JASON H.P. KRAVITT ET AL., SECURITIZATION OF FINANCIAL ASSETS (2010) § 17.05 n.386.

<sup>91</sup> CONN. GEN. ST. ANN. § 38a-102i. Connecticut permits insurers to make any investments that are "prudent in respect of the business of [the] insurance company and diversification considerations," *Id.* §38a-102(a), subject to limits on the percentage of assets that may be invested in the portion of mortgages that exceeds a 75% loan to value ratio. *Id.* § 38a-102c(f)

<sup>92</sup> N.Y. INS. L. § 1401(c). New York permits insurers to invest in notes backed by first and second mortgages meeting specified loan-to-value thresholds. *See* N.Y. INS. LAW § 1404(a)(4).

<sup>93</sup> *See, e.g.,* MINN. STAT. ANN. § 61A.28, subd. 3; N.J. STAT. ANN. §17B:20-1(c); CAL. INS. CODE §§ 1177 (non-excess funds -- notes backed by insured mortgages), 1194.81-82 (excess funds -- notes backed by first or second mortgages that meet combination of loan-to-value, mortgage insurance, and amortization requirements); N.J. STAT. ANN. § 17B:20-1(c) (mortgages meeting combination of loan-to-value, agency guarantee, and amortization requirements).



*iii. Structured Products Other than  
Mortgage-Backed Securities*

Minnesota and California have rating-based rules that expressly govern insurers' investments in structured or asset-backed securities.<sup>94</sup> Other states, such as Massachusetts,<sup>95</sup> have rating-dependent provisions that are drafted broadly enough to cover such investments, even if the term "asset-backed" or "structured" is not used. Still others, such as New York, permit insurers to invest in obligations with high ratings issued by "institutions" without defining that term.<sup>96</sup>

*iv. Non-U.S Investments*

Ratings determine the eligibility of non-U.S. investments for insurer investment in New York,<sup>97</sup> Minnesota,<sup>98</sup> and New Jersey.<sup>99</sup>

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<sup>94</sup> MINN. STAT. ANN. § 61A.28, subdiv.. 8(b) (West 2005) (permitting investment in asset-backed arrangements in which at least 90 percent of the dollar value of the assets are eligible for direct investment or that have a rating in the top four categories from at least one NRSRO or in the top two categories from SVO); CAL. INS. CODE §1192.10(a)(3) (West 2005) (permitting asset-backed security investments that have ratings in one of three highest categories by at least one NRSRO and one of the two highest NAIC categories). Such investments are limited to 10% of an insurer's total admitted assets. *Id.* § 1192.10(b).

<sup>95</sup> See MASS. GEN. LAWS ch. 175 § 63(14G) (supp. 2010). Section 14G permits investment in obligations of U.S. and Canadian "institutions," as defined in §63A(1) subject to rating requirements. Section 63A(1) in turn defines "institution" as "a corporation, a joint-stock company, an association, a trust, a business partnership, a business joint venture or similar entity." This definition is broad enough to include typical structured products, which are issued by trusts. The specific rating requirement of Section 63(14G) is that the product initially be rated "at least BBB- or Baa3 or the equivalent thereof" by an NRSRO recognized by SVO and receive an initial or provisional rating of in the top two categories from SVO directly or via a filing exemption. *Id.* § 63(14G)((1)-(3). California likewise defines "institution" broadly to include business trusts. See CAL. INS. CODE § 1192 (West 2005) (authorizing investment in "interest-bearing obligations issued by a nonaffiliate institution"); *id.* §1196.1(f)(5) (defining "institution" to include "business trust"). See *infra* note 92 and note 113, (Although California does not impose a rating threshold on individual investments, it does limit aggregate investments in low-rated obligations of "institutions.").

<sup>96</sup> N.Y. INS. LAW § 1404(a)(2). (McKinney 2006).

<sup>97</sup> See *id.*, § 1404(a)(6) (permitting non-life insurers to make foreign investments "substantially of the same ... investment grades as those eligible for

*b. Aggregate Exposure Limits*

Even when state laws do not use ratings to specify permitted investments, they often require insurers' portfolios to satisfy rating requirements in the aggregate. For example, in Minnesota, insurers other than life insurers may invest only up to 15 percent of total admitted assets in noninvestment grade obligations,<sup>100</sup> which are defined in terms of ratings.<sup>101</sup> California<sup>102</sup> and Massachusetts<sup>103</sup> impose the same rating-based limits on aggregate holdings of medium- and low-quality investments as the Model Act. Connecticut limits the percentage of assets

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investment under other provisions of this section"); § 1405(a)(7)(C)(i)(I) (permitting life insurers to make foreign investments in governments or institutions of countries "rated in one of the three highest rating categories by an independent, nationally recognized United States rating agency").

<sup>98</sup> MINN. STAT. ANN. § 61A.29, subdiv. 2(a) (West 2005) (requiring that sovereign debt have a rating in the top two categories from an NRSRO to be eligible for investment); *id.* subdiv. 2(b) (requiring that obligations of a foreign business entity have a rating in the four highest categories from an NRSRO "or by a similarly recognized statistical rating organization, as approved by the commissioner, in the country where the investment is made," or have a rating in the highest two categories from SVO); *id.* § 60A.11, subdiv. 14(a)(ii) (permitting life insurers to invest in obligations of non-U.S. banks only if the debtor bank "has a long-term deposit rating or a long-term debt rating of at least Aa2 as found in the current monthly publication of Moody's Credit Opinions or its equivalent.").

<sup>99</sup> See N.J. STAT. ANN. § 17B:20-1(e)(1)(a) (West 2006) (limiting investments to those in obligations of institutions or governments of jurisdictions "rated in one of the two highest categories by an independent, nationally recognized United States rating agency."); *id.* 17B:20-1(e) (A life insurer may invest up to 3% of aggregate assets in aggregate in countries that do not meet the rating standard).

<sup>100</sup> See MINN. STAT. ANN. § 60A.11, subdiv. 17(d) (West 2005).

<sup>101</sup> See *id.* § 60A.11, subdiv. 10(i) (defining "noninvestment grade obligations" as "obligations which, at the time of acquisition, were rated below Baa/BBB or the equivalent by a securities rating agency or which, at the time of acquisition, were not in one of the two highest categories" established by SVO).

<sup>102</sup> See CAL. INS. CODE § 1196.1(a)(6) (West 2005) *Compare id.* § 1196.1(a) with NAIC MODEL LAWS, REGULATIONS, AND GUIDELINES 280-1 § 10.B (2001). California law also provides that affiliated insurers may invest in "cash management pools" that hold corporate debt obligations, as long as the obligations have a maturity of less than one year and carry an NAIC-1 or NAIC-2 rating.

<sup>103</sup> MASS. GEN. LAWS ch. 175 § 63A(1) (West 1998) (defining "medium grade obligation" and "lower grade obligations" in terms of NAIC ratings); *id.* § 63A(2) (limits on investment in medium and lower-grade bonds).

that can be invested in “high yield obligations,”<sup>104</sup> as defined by ratings.<sup>105</sup>

*c. Concentration Limits*

Most states’ laws prohibit insurers from investing more than a specified fraction of their assets in any one particular entity. For example, New York law prohibits insurers from investing more than 10 percent of admitted assets in securities of any one institution.<sup>106</sup> Here again, ratings may come into play. In New York, “mortgage-related securities” – defined by rating<sup>107</sup> -- are simply exempted from the concentration-limit rule.<sup>108</sup>

*d. Pool Requirements*

Most states authorize insurers to participate in investment pools. Some insurance groups pool investments from multiple regulated insurance subsidiaries, presumably to exploit economies of scale. AIG’s securities-lending travails arose from such pooling activity.<sup>109</sup> Such insurance pools are often subject to rating-dependent regulation and often are required to invest only in instruments that the insurers contributing the funds could invest in.

New Jersey generally does not impose rating-dependent investment limits on property and casualty insurers, although it has adopted Section 25 of the Model Investment Act (Defined Limits Version), dealing with investment pools.<sup>110</sup> Notably, it appears that New Jersey law generally

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<sup>104</sup> CONN. GEN. STAT. § 38a-102c(c) (2007) (limiting high-yield investments to 10% of admitted assets).

<sup>105</sup> *Id.* § 38a-102b(c) (2007) (defining “high yield obligations” as those that “are not rated as investment grade by any nationally recognized United States rating agency” or NAIC).

<sup>106</sup> N.Y. INS. LAW § 1409(a) (McKiney 2006) (“[N]o domestic insurer shall have more than 10 percent of its admitted assets...invested in, or loaned upon, the securities...of any one institution.”). New York’s rating-based definition of a mortgage-related security parallels the federal definition. *Compare* 15 U.S.C. § 78c(1)(41).

<sup>107</sup> *Id.* § 1401(a)(2) (“‘Mortgage-related security’ means an obligation that is rated AA or higher (or the equivalent thereto) by a nationally recognized securities rating agency” and meets other criteria).

<sup>108</sup> *Id.* § 1409(c) (10 percent limit does not apply to “mortgage-related securities” or securities issued or guaranteed by Fannie Mae or Freddie Mac).

<sup>109</sup> *See infra* note 269.

<sup>110</sup> *See* N.J. STAT. ANN. §§ 17:24-28 to -36. (West 2007).

does not authorize property and casualty insurers to invest in corporate bonds or asset-backed securities other than mortgage-backed securities, which are not defined in terms of ratings.<sup>111</sup>

*e. Derivative Exposures*

Ratings also play a role under New York law in defining the parties with whom insurers can enter into derivatives transactions. Insurers are prohibited from amassing derivative exposure of more than 3 percent to parties other than “qualified counterparties.”<sup>112</sup> “Qualified counterparties” are “qualified banks,” “qualified broker-dealers” and other counterparties “rated AA-/Aa3 or higher by a nationally recognized statistical rating organization” and approved by the Superintendent of Insurance.<sup>113</sup> A “qualified bank” in turn is defined as one that is AA-rated.<sup>114</sup> Although “qualified broker-dealer” is defined in terms of size and not rating,<sup>115</sup> ratings also are relevant in that any derivative exposure to a counterparty is treated as an obligation of that counterparty,<sup>116</sup> so that non-life insurers apparently can take derivative exposure only to counterparties meeting rating requirements according to the rules for investment in obligations of U.S. companies.

*f. Non-Rating-Based Authorizations*

State statutes often will authorize investments without regard to ratings. In addition to the common practice of permitting mortgage-backed security investments without regard to ratings described above, California,<sup>117</sup> Connecticut,<sup>118</sup> New Jersey,<sup>119</sup> Massachusetts,<sup>120</sup>

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<sup>111</sup> See *id.*, § 17:24-1.

<sup>112</sup> N.Y. INS. LAW § 1410(f)(2)(A) McKinney 2006).

<sup>113</sup> *Id.* § 1410(f)(3)(A).

<sup>114</sup> *Id.* § 1410(f)(3)(C)(iv).

<sup>115</sup> *Id.* § 1410(f)(3)(B).

<sup>116</sup> *Id.* § 1410(f)(1).

<sup>117</sup> See Cal. Ins. Code § 1192(a) (West 2005) (corporate bonds);

<sup>118</sup> CONN. GEN. STAT. § 38a-102(a) (2010) (Insurers may make all such investments “as are prudent in respect of the business ... and diversification consideration.”)

<sup>119</sup> N.J. STAT. ANN. § 17B:20-1(d) (West 2005) (authorizing New Jersey life insurers to invest in corporate bonds without regard to ratings). The law does not appear to specify any standard of creditworthiness for these investments. See *id.*

Minnesota,<sup>121</sup> and New York<sup>122</sup> all expressly permit certain types of investments without regard to rating. When ratings are not required for individual investments, the statute often provides that the insurer must make only “prudent”<sup>123</sup> or “sound”<sup>124</sup> investments.

g. Catch-all Provisions

Even when rating-dependent requirements limit insurer investments, state investment laws typically provide “catch-all provisions” that permit investments of relatively modest size in instruments that do not meet other requirements.<sup>125</sup>

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<sup>120</sup> MASS. GEN. LAWS ch. 175 § 63(7) (West 2010) (real-estate loans); *id.* § 63(14A) (corporate bonds). MassMutual and its two principal insurance subsidiaries, C.M. Life and MML Bay State Life, are domiciled in Massachusetts.

<sup>121</sup> *See* MINN. STAT. ANN. § 60L.02 (West 2010) (requiring \$2 billion in admitted assets, NRSRO rating in one of the three highest categories, plus other criteria, for exemption eligibility)

<sup>122</sup> New York is the principal regulator for the New York Metropolitan Life Insurance Company, as well as for insurance subsidiaries of AIG. N.Y. INS. LAW § 1405(a)(2) (McKinney 2010) (preferred stock); *id.* § 1405(a)(3) (obligations secured by real property); *id.* § 1405(a)(5) (obligations secured by personal property).

<sup>123</sup> CONN. GEN. STAT. § 38a-102(a) (insurers may make all such investments “as are prudent in respect of the business ... and diversification consideration.”); N.Y. INS. LAW § 1405(c) (requiring directors and officers to use “that degree of care that an ordinarily prudent person in a like position would use under similar circumstances” in making investments); *see* MINN. STAT. ANN. § 60L.04, subdvs. 1-2 (authorizing insurer exempt from default investment rules to “loan or invest its funds ... to the same extent as any other corporation or person under the laws of this state or the United States,” but requiring that board of directors “exercise the judgment and care ... that persons of reasonable prudence, discretion, and intelligence exercise in the management of a like enterprise”); *id.* § 60L.05(5) (establishing “the extent of the diversification of the insurer’s investments” as a criterion for evaluating prudence of investment). Connecticut is the domiciliary state for major insurance subsidiaries of The Travelers Group and The Hartford.

<sup>124</sup> CAL. INS. CODE § 1196(a) (West 2005). California is the domiciliary state for the major insurance subsidiaries of Farmers Group, Inc. (which are organized as inter-insurance exchanges under California law), as well as of a major insurance subsidiary of Allstate

<sup>125</sup> *See, e.g.,* MINN. STAT. ANN. § 61A.28, subdvv. 12; CAL. INS. CODE § 1210.

#### IV. THE FINANCIAL CRISIS AND THE FAILURE OF RATINGS ON NOVEL, UNSEASONED PRODUCTS

The way in which ratings were incorporated into the regulatory system made it possible for insurers to take on exposures to novel financial products such as subprime and Alt-A residential mortgage-backed securities and collateralized debt obligations. The capital requirements regime was built around agency credit ratings, and in many instances state investment laws directly required high ratings for insurer investment in novel instruments.

During the financial crisis that started in 2007, these products also suffered a high incidence of large credit-rating downgrades that can be described as unexpected, even unprecedented. Although it will always be possible to argue that the ratings did not “fail” in some sense, all the major credit rating agencies have conceded that their ratings on novel products did not perform as well as intended during the financial crisis.

Although the solvency-rated U.S. insurance industry reportedly fared better in the financial crisis starting in 2007 than the banking industry, the poor performance of formerly high-rated novel products did create some important problems for the industry. The underperformance of such products was quite important to the failure of the bond insurance industry and of AIG, although it can be argued that the latter case does not impugn the existing capital and investment requirements for regulated insurers as the fatal exposures were undertaken by an unregulated affiliate of the insurance companies. The poor performance of life insurers’ novel-product investments also put stress on that segment of the industry, leading to regulatory changes as described in Part IV, below.

##### A. Subprime and Alt-A RMBS and CDOs Are Novel

###### 1. Subprime and Alt-A RMBS

Residential mortgage-backed securities (RMBS) are not particularly novel – the first private-label securitization dates to 1983 – but MBS backed by subprime and “Alt-A” mortgages extended to borrowers with poor credit are of more recent vintage. A 2007 study put it thus: “Until very recently, the origination of mortgages and the issuance of mortgage-backed securities was dominated by loans to prime borrowers conforming to underwriting standards set by the Government Sponsored

Agencies.”<sup>126</sup>

One highly influential account, by Gary Gorton, describes subprime and Alt-A mortgages as reflecting a distinctive, novel security design for a distinctive purpose: enabling the lender to lend profitably to borrowers with poor credit risk.<sup>127</sup> He emphasizes the prepayment penalty and interest step-up features of subprime RMBS in describing such mortgages as effectively creating “compound options” on the underlying property for the lender, thereby increasing the lender’s exposure to home price appreciation.<sup>128</sup> Whether one accepts this specific explanation or not, secured lending based on collateral value rather than the borrower’s ability to repay has to increase the lender’s sensitivity to collateral price changes. Rating conclusions based on the history of prime RMBS thus were less relevant to these securities.<sup>129</sup>

The scale of subprime and Alt-A issuance is certainly a novel phenomenon. As recently as 2001, subprime and Alt-A securitization totaled \$98.5 billion, as compared to \$1,087.6 billion for agency-backed securitizations and total mortgage origination of \$2,100 billion.<sup>130</sup> By 2006, subprime and Alt-A securitization was \$814.3 billion, as compared to \$904.6 billion in securitizations by government-sponsored entities, such as Fannie Mae and Freddie Mac.<sup>131</sup> This reflected a massive expansion in the extent of subprime mortgage origination<sup>132</sup> and a doubling in the

<sup>126</sup> Adam B. Ashcraft & Til Scheuermann, Understanding the Securitization of Subprime Mortgage Credit, 2 (March 2008) (unpublished manuscript) (on file with the Federal Reserve Bank of New York).

<sup>127</sup> Gary Gorton, *The Subprime Panic*, 4 (Yale Int’l Ctr. For Fin. , Working Paper No. 08-25, 2008)

<sup>128</sup> *Id.* at 5.

<sup>129</sup> See FINANCIAL CRISIS INQUIRY COMMISSION, FINANCIAL CRISIS INQUIRY REPORT 118 (2011) (“Moody’s did not even develop a model specifically to take into account the layered risks of subprime mortgages until late 2006, after it had already rated nearly 19,000 subprime securities”) *l. id.* at 120-21 (describing evolution of Moody’s models). Although four of the ten members of the Financial Crisis Inquiry Commission dissented from the report in two separate dissent, none of dissenters contested the majority’s findings about ratings on subprime RMBS, and the dissent in which three of the four dissenting commissioners joined stated that one of the “ten essential causes” of the crisis was “failures in credit ratings and securitization.” *Id.* at 418.

<sup>130</sup> Ashcraft & Scheuermann, *supra* note 124, at 7 (jumbo originations, i.e. mortgages to prime borrowers that were too large to meet GSE guidelines -- and originations that were not securitized made up the difference).

<sup>131</sup> *Id.* at 7

<sup>132</sup> Jie He , Jun Qian & Philip E. Strahan. Credit Rating and the Evolution of

percentage of subprime mortgages that were securitized.<sup>133</sup> Although there is no universally accepted definition of a “subprime” mortgage, one estimate is that total *origination* of subprime mortgages increased from \$65 billion in the late 1990s to over \$600 billion in 2006, with subprime accounting for about a third of total mortgage volume in 2006.<sup>134</sup>

## 2. Growth of the CDO Market

CDOs can be defined as structured finance securities in which the cash flows from a pool of assets are divided into senior and junior debt classes, called “tranches.”<sup>135</sup> The CDO market exploded in the years leading up to the crisis, with global CDO issuance going from \$157.4 billion in 2004 to \$551.7 billion in 2006.<sup>136</sup> The number of CDO tranches issued nearly doubled from 2005 (4,708 tranches) to 2006 (9,278 tranches).<sup>137</sup>

### B. EVIDENCE SUGGESTING THAT RATINGS ON RMBS AND CDOs FAILED

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the Mortgage-backed Securities Market, 6 (March 2010) (unpublished manuscript, on file with Boston College Department of Finance) (subprime origination increased from \$65 billion around the turn of the century to over \$600 billion in 2006). Subprime reportedly accounted for 13% of total mortgage origination in 2007. HAL S. SCOTT, *THE GLOBAL FINANCIAL CRISIS 2* (2009).

<sup>133</sup> SCOTT, *supra* note 424-132, at 3 (proportion of subprime mortgages securitized rose from 46% to 93% from turn of the century to 2006)/

<sup>134</sup> He, Qian & Strahan, *supra* note 424-132 at 6; SCOTT, *supra* note 424-132, at 2.

<sup>135</sup> Efraim Benmelech & Jennifer Dlugosz, *The Credit Rating Crisis* 6; (Nat'l Bureau of Econ. Research, Working Paper No. 15045); *see also* Dan Luo, Dragon Yong Tang & Sarah Qian Wang, A Little Knowledge is a Dangerous Thing: Data History, Model Uncertainty, and CDO (Mis-)Pricing 4 (November 15, 2008) (unpublished manuscript) (on file with the School of Economics and Finance, University of Hong Kong) *available at* [www.fma.org/iamen/BayesianCDO.pdf](http://www.fma.org/iamen/BayesianCDO.pdf) (CDO issuance grew from \$17 billion in 1997 to over \$500 billion in 2006-07). Some commentators use a more general definition of CDO that would include non-tranched structures. “CDOs entail the use of securitisation techniques to create structured exposure to portfolios of multiple reference entities.” SATYAJIT DAS, *CREDIT DERIVATIVES, CDOs & STRUCTURED CREDIT PRODUCTS* 305-06 (3d ed. 2005).

<sup>136</sup> Benmelech & Dlugosz, *supra* note 135-24, at 7.

<sup>137</sup> *Id.* at 7.



Structured products in general suffered a high rate of severe downgrades in 2007 and 2008. 7.2% and 6.7% of tranches rated by Moody's were downgraded in 2007 and 2008 respectively, and the average downgrade was 4.7 and 5.6 notches.<sup>138</sup> This compares to an average rate of downgrade on structured-finance securities of 1-2% per year.<sup>139</sup> The majority of the downgrades were on securities backed by first mortgages, home equity loans (a category that apparently includes subprime loans), and CDOs of ABS.<sup>140</sup>

One leading commentator puts it as follows: "Events since mid-2007 have demonstrated that the major [rating agencies] grossly underestimated the risk of loss associated with several types of structured financial products that lay at the heart of the financial crisis."<sup>141</sup>

### 1. RMBS

About 90% of rated RMBS value issued in the U.S. from 2003 to 2006 received AAA ratings, and 99.76% of rated issuance received investment-grade ratings.<sup>142</sup> Between December 2007 and September 2008, these securities experienced an extraordinarily high downgrade rate. Adelino studies a sample covering 80% of RMBS issued in the U.S. between 2003 and 2007,<sup>143</sup> documenting the rapid growth of the market during this period.<sup>144</sup> Adelino does not distinguish between subprime/Alt-A and conventional RMBS. The proportion of AAA-rated securities that had been downgraded went from 0.5% to 16.2%, with equally dramatic increases in downgrades among the lower rating classes.<sup>145</sup> AAA-rated RMBS had not yet been hit by a high level of default at the time of Adelino's study, although there were a few defaults even in this category.<sup>146</sup> Nevertheless, the level of downgrades was significant.

<sup>138</sup> *Id.* at 24.

<sup>139</sup> *Id.* at 24.

<sup>140</sup> *Id.* at 25.

<sup>141</sup> SCOTT, *supra* note 13224, at 125.

<sup>142</sup> See Manuel Adelino, *Do Investors Rely Only on Ratings? The Case of Mortgage-Backed Securities* 13, 42 tbl.1 (Nov. 24, 2009) (unpublished working paper) (on file with author).

<sup>143</sup> *Id.* at 10.

<sup>144</sup> *Id.* at 42 tbl.1 (RMBS issuance covered by sample increased for \$496.5 billion in 2003 to \$1,080.4 billion in 2006).

<sup>145</sup> *Id.* at 43 tbl.2.

<sup>146</sup> *Id.* at 43 tbl.3 (0.4% of 2006-issued AAA RMBS had defaulted by September 2008).

Ratings are designed to be stable through the credit cycle, so mass downgrades are themselves a sign of trouble. As Adelino points out, the 16% downgrade rate for AAA-rated RMBS issued between 2003 and 2006 contrasts with a historical one-year probability of downgrade on triple-A structured finance instruments is less than 1 percent.<sup>147</sup> By June 2009, Bank of America Merrill Lynch reported that over 64% of all AAA rated non-agency RMBS had been downgraded to below investment grade by at least one rating agency.<sup>148</sup>

Ashcraft catalogues a series of what he describes as “honest mistakes” in rating RMBS, including underestimating the severity of the housing cycle and model error brought on by “the lack of comprehensive historical data,” particularly with respect to subprime mortgages, for which historical data was “largely confined to a relatively benign economic environment with very little data on periods of significant negative home price appreciation.”<sup>149</sup>

## 2. CDOs

CDOs experienced a large number of severe downgrades in 2007 and 2008, accounting for 13% of structured-finance downgrades in 2007 and 22% in 2008.<sup>150</sup>

The performance of ABS CDOs – CDOs where structured products such as CDOs and MBS make up the underlying pool of assets – is of particular interest because of ABS CDOs’ role in the collapse of monoline insurers. By January 2008, 17.35% of ABS CDOs insured by MBIA and Ambac had been downgraded at least once, with only 3.63% upgraded.<sup>151</sup> Barnett-Hart’s examination of a different sample of ABS CDOs reveals that AAA tranches from 2005, 2006, and 2007 had been downgraded to average ratings of BBB, B-, and CCC+ respectively by June 2009.<sup>152</sup>

Many CDOs were made out of RMBS – for example, around 70% of ABS CDOs insured by Ambac and MBIA had RMBS or home equity as

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<sup>147</sup> *Id.* at 15.

<sup>148</sup> Letter from John Bruins and Andrew Melnyk, ACLI, to Lou Felice and Michael Moriarty, NAIC (Sept. 10, 2009) (on file with NAIC).

<sup>149</sup> Adam B. Ashcraft, Discussion of Alchemy of CDO Ratings, 56 J. OF MONETARY ECONOMICS 635, 637 (2009).

<sup>150</sup> Benmelech & Dlugosz, *supra* note 424, at 33 tbl.4.

<sup>151</sup> *Id.* at 18.

<sup>152</sup> Anna Katherine Barnett-Hart, The Story of the CDO Market Meltdown: An Empirical Analysis 24 fig.10 (Mar. 19, 2009) (unpublished A.B. honors thesis, Harvard College) (on file with Harvard College).

collateral<sup>153</sup> – and for those CDOs any errors in rating RMBS would have been compounded.<sup>154</sup>

Because of the tranching structure common to CDOs, a critical aspect of CDO rating and pricing is the correlation of defaults among the underlying assets of the CDO. If raters rate the correlation too low, then the ratings will be too high. If market participants assess the correlation as too low, then the tranche prices will be too high. Default correlation, however, is difficult to estimate accurately because defaults are generally relatively rare events. It is widely believed that rating agencies and the market assessed CDOs' assets' correlation as too low, resulting in over-rated and over-priced CDOs.<sup>155</sup> For example, a *national* decline in real-estate prices would result in a lot of homeowners defaulting on their mortgages at once (i.e., in a highly correlated fashion). Some researchers have argued that CDOs were inherently difficult for any market participant to evaluate because of limited data<sup>156</sup> and fundamentally flawed models,<sup>157</sup> so that ratings were more or less destined to be of low quality. More jaundiced observers point to the fact that one rating agency's model for CDOs based on corporate bonds assumed no correlation between companies in different industries.<sup>158</sup>

### 3. Other Examples of Novel-Product Rating Failure

It is sometimes argued that the underlying problem with ratings on novel products in the financial crisis was a generally unanticipated national decline in house prices. Although this certainly contributed to the collapse of RMBS and CDO valuations, there are examples of rating failure on

<sup>153</sup> Benmelech & Dlugosz, *supra* note 424135, at 15.

<sup>154</sup> See Ashcraft, *supra* note 13498, at 638 (arguing that CDO investors did not “look through” credit ratings on RMBS to underlying collateral, instead “focusing on Monte Carlo simulations which took the CRAs’ view of nonprime RMBS as given.”).

<sup>155</sup> See, e.g., Luo et al., *supra* note 13524, at 5.

<sup>156</sup> *Id.* at 2 (“Because defaults are rare and credit cycles take a long time to materialize . . . a short data history, say, five years of month[ly] observations, will significantly underestimate the tail distribution of the credit portfolio and default correlation.”).

<sup>157</sup> *Id.* at 3. Luo et al.’s comment about model error reflects their view that a very specific model change (to incorporate a “frailty factor”) is highly desirable. The authors’ point about short data histories survives and is independent of this very specific and contestable view about appropriate models. *Id.*

<sup>158</sup> Benmelech & Dlugosz, *supra* note 424135, at 20.

specific novel products that are not tied to housing or real estate. For example, the market for CPDOs (“collateralized proportional debt obligation”), a novel product introduced in 2006, collapsed in 2007 after a wave of downgrades. The underlying asset for a CPDO is an index of corporate credit spreads and the product has no direct connection to real estate.<sup>159</sup> The rise and fall of collateralized bond obligations (CBOs) tells a similar story. Issuance of this product rose from approximately zero in 1994 to \$25 billion in 2000. By 2003, issuance was back to zero after a rash of downgrades. The CBO market had recovered to the \$3-\$5 billion level by 2007-08, suggesting the possibility that market participants had recovered confidence on ratings on this product.<sup>160</sup>

### C. LOSSES ON RMBS AND CDOs HARMED INSURERS

#### 1. Financial Guaranty Insurers

The exposure of financial guaranty insurers such as Ambac and MBIA to ABS CDOs is a well-known part of the story of their downfall. Monoline insurers apparently took on a large proportion of the credit exposures created by high-rated CDO tranches. S&P estimated that FGI firms backed \$127 billion in CDOs with some subprime loan exposure.<sup>161</sup> Gorton estimates that FGIs held 26% of AAA CDO tranches.<sup>162</sup> The two largest bond insurers, Ambac and MBIA, had each sold CDS protection on around \$30 billion of CDO exposure by 2007.<sup>163</sup> These CDO exposures, which have been described as the “principal reason for Ambac’s significant losses” during the financial crisis, led to mark-to-market losses of \$5.9 billion in 2007 and \$4.0 billion in 2008 and created a \$10 billion liability

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<sup>159</sup> John Patrick Hunt, *Credit Rating Agencies and the “Worldwide Credit Crisis”: The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, 2009 COLUM. BUS. L. REV. 109, 123 (2009) [hereinafter Hunt, *CRA and the WWCC*].

<sup>160</sup> See Benmelech & Dlugosz, *supra* note 424, at 24, fig.6a.

<sup>161</sup> SCOTT, *supra* note 424, at 5.

<sup>162</sup> See Pamela Peterson Drake & Faith Roberts Neale, *Financial Guarantee Insurance and the Failures in Risk Management* 17 n.60 (May 2010) (unpublished working paper) (citing Gorton).

<sup>163</sup> Robert P. Bartlett, III, *Inefficiencies in the Information Thicket: A Case Study of Derivative Disclosures During the Financial Crisis* 5 (UC Berkeley Public Law Research Paper No. 1585953, Mar. 15, 2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1585953](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1585953).

on the company's balance sheet.<sup>164</sup> By March 2010, MBIA had actually paid \$3.8 billion in claims on RMBS exposures and had a negative unassigned surplus, which prevented it from writing new business.<sup>165</sup>

## 2. AIG

AIG had written CDS protection on \$61.4 billion on multi-sector CDOs with subprime housing exposure by 2007.<sup>166</sup> AIG suffered write-downs to its CDS portfolio totaling \$11 billion in 2007 and \$20 billion in the first nine months of 2008.<sup>167</sup> Under the CDS agreements, AIG was required to post collateral on account of the write-downs, and collateral calls in July and August 2008 totaled \$6 billion, or about 1/3 of the cash AIG had on hand as of July 1.<sup>168</sup> When AIG lost its AAA credit rating on September 15, 2008, this triggered a further \$20 billion in collateral calls under the agreements, plunging AIG into distress and leading to its government bailout the next day.<sup>169</sup>

AIG also had cash difficulties arising from its securities lending program, because it received cash collateral in exchange for lending out high-quality securities and invested that cash in RMBS. When AIG's counterparties became concerned about AIG's situation, returned the lent securities, and demanded return of the cash collateral, AIG was not able to sell the RMBS, so that its cash was further drained, to the tune of \$3.3 billion through August 31, 2008.<sup>170</sup>

## 3. Life Insurers

Life insurers held substantial amounts of non-agency RMBS -- \$145 billion as of year-end 2008.<sup>171</sup>

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<sup>164</sup> *Id.* at 27.

<sup>165</sup> *Moody's Comments on MBIA's Fourth Quarter Earnings and Ongoing Litigations*, (Mar. 5, 2010), [http://www.mbia.com/investor/ratings/Moodys\\_030510.pdf](http://www.mbia.com/investor/ratings/Moodys_030510.pdf).

<sup>166</sup> William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 943, 959 (2009).

<sup>167</sup> *See id.* at 960.

<sup>168</sup> *Id.* at 961.

<sup>169</sup> *Id.* at 962.

<sup>170</sup> *Id.* at 962–63.

<sup>171</sup> ACLI Letter, *supra* note [437148](#), at 3.

D. RATING FAILURE, RATING AGENCY FAULT, AND THE IMPORTANCE OF SEASONING

The debate over whether rating agencies are at fault for poor-quality ratings, by committing a species of fraud or otherwise, focuses attention on whether agency ratings were as good as could be reasonably expected.<sup>172</sup> But even if ratings were as good as could be expected, that does not necessarily mean that they were good enough for any and all purposes. If ratings on novel products are unreliable because of a lack of data on the products' performance and experience in modeling the products, then permitting an regulated insurer to invest in that product on the basis of the rating is a questionable decision, even if the rating agency did as well as it could have done or as well as the average or above-average investor could have done.

A corollary to this is that one would expect ratings to become more reliable over time with the accumulation of data and experience. Indeed, the major rating agencies already have comprehensively revamped their rating methodologies for RMBS and CDOs as a result of the crisis. It seems to make more sense to give regulatory effect to ratings after the end of an appropriate seasoning period than to do so immediately and without regard to whether ratings on the product have proven themselves reliable.

V. THE NAIC'S RATING AGENCY WORKING GROUP: FIXING RATINGS VERSUS REGULATING INSURANCE

The NAIC's risk-based capital framework and federal and state

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<sup>172</sup> See, e.g., *Anschutz Corp. v. Merrill Lynch & Co., Inc.*, 2011 WL 1134321 (N.D. Cal. March 27, 2011) (denying rating agencies' motion to dismiss negligent misrepresentation claims based on agencies' award of AAA ratings to auction-rate securities); *In re Bear Stearns Cos., Inc. Secs. Litig.*, 2011 WL 321142 (Feb. 1, 2011) ; *King County v. IKB Deutsche Industriebank AG*, 708 F. Supp. 2d 334 (S.D.N.Y. 2010) (denying rating agencies' motion to dismiss common-law fraud claims based on agencies' award of AAA ratings securities issued by Rhinebridge SIV (structured investment vehicle)); *Abu Dhabi Commercial Bank v. Morgan Stanley & Co.*, 651 F. Supp. 2d 155 (S.D.N.Y. 2009) (denying rating agencies' motion to dismiss common-law fraud claims based on agencies' award of AAA ratings to securities issued by Cheyne SIV (structured investment vehicle)); *California Public Employees' Retirement Sys. v. Moody's Corp.* (Cal. Super. Ct. May 24, 2010) (overruling rating agencies' demurrer to claim for negligent misrepresentation based on award of AAA ratings to Cheyne, Stanfield Victoria, and Sigma Finance SIVs (structured investment vehicles)).

investment laws have conferred an important gatekeeping role on credit ratings. In many cases, a recognized rating agency's decision to rate an investment product authorizes insurers to invest in that product.<sup>173</sup> This is important because insurers are responsible for a large fraction of fixed-income investment. Some rating-dependent rules rely on high ratings, as explained above, and thus may encourage ratings inflation. But all rating-dependent rules depend on the fact of receiving a rating, and none expressly distinguishes between ratings that are likely to be reliable and ratings that are less likely to be reliable.<sup>174</sup> This is curious, because the reliability of a rating ought to be as important for regulation as how high the rating is.

The apparent failure of ratings on a number of products<sup>175</sup> has led state insurance regulators to reexamine the role of ratings in their regulations. Although this reexamination was initially quite broad-ranging, it has narrowed significantly in scope. It now seems unlikely that the NAIC will abandon credit ratings completely. Credit ratings offer insurers and their regulators credit assessments at low cost, and historically ratings from the major agencies have enjoyed a fairly high degree of market acceptance. The insurers who foot the bill for regulatory credit determinations historically have liked the arrangement, citing its low cost. Regulators may not want the large, difficult and unrewarding task of making credit assessments on thousands of different financial instruments. Most importantly, there are no terribly appealing alternatives to rating-dependent regulation or something very much like it.<sup>176</sup>

Against this backdrop, it is no surprise that the NAIC does not seem to be on a path to complete elimination of ratings from its regulations. The NAIC is not alone among regulators in its reluctance to follow that

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<sup>173</sup> See discussion *supra* Part II.B.

<sup>174</sup> The fact that only ratings from approved agencies "count" under NAIC rules, see *supra* note 658, attempts to distinguish between reputable and nonreputable rating agencies, but no finer distinction appears in the NAIC rules. The rules do not contemplate the possibility that an agency might do a good job on some ratings and not others.

<sup>175</sup> See discussion *supra* Part III.

<sup>176</sup> Although the NAIC has replaced credit ratings on some structured financial products with outsourced assessments provided by private parties that are not rating agencies, see discussion *infra* Part IV.B.3, the new arrangement seems to exhibit many of the same benefits and potential problems as rating-dependent regulation. It is not too much of an exaggeration to say that the shift is better understood as a change in the *form* of rating-dependent regulation than as a move away from rating-dependent regulation to something else.

path to its end – for example, the SEC also tabled reforms of rating-dependent regulation until commanded by Congress to eliminate ratings.

Rating-agency reformers, by contrast, are often quite eager to eliminate credit ratings from regulation, pointing to the way in which ratings warp agencies' incentives and arguing that ratings are generally uninformative. (Indeed, the two largest rating agencies themselves voice agreement with the first statement, although not the second.) It seems that there is a persistent conflict between capital regulators and rating-agency reformers on this score.

The rating-agency reformers won out in the Dodd-Frank Wall Street Reform and Consumer Protection Act, which seems to require elimination of credit ratings from federal regulation, and which removes a number of federal statutory requirements that incorporate credit ratings into financial regulation<sup>177</sup> – including the provision of SMMEA that requires state insurance regulators to permit insurers to hold high-rated mortgage-backed securities<sup>178</sup>. As one might anticipate, federal regulators are resisting this mandate. Even apart from that, state insurance regulators' reluctance to give up on rating-dependent regulation threatens to undermine the federal goal of improving rating agencies' incentives by eliminating rating-dependent regulation. The use of ratings in capital regulation threatens to become a source of tension in the ongoing struggle between state and federal authority in the regulation of insurance.

If regulators were to rely only on ratings on seasoned products – products in existence long enough for analysts to have a good sense of how the product is likely to perform under various economic conditions – that would accommodate the most important interests both of those who want to rely on credit ratings and of rating-agency reformers who want to minimize reliance on such ratings. Regulators and regulated parties could continue to rely on ratings for traditional products, preserving the low cost of the rating-dependent system and addressing any concerns regulators might have about being made responsible for routine credit determinations.

A seasoning requirement therefore is a feasible solution to the conflict between regulators and rating-agency reformers. A seasoning requirement also would mitigate the major problems with rating-dependent regulation. The worst-performing ratings have been on novel products, as one might expect given the agencies' lack of experience with them. And it is in the context of certifying novel products for acceptance that rating-dependent regulation has its worst effects on agency incentives for quality.

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<sup>177</sup> PUB. L. 111-203 (July 21, 2010) §939.

<sup>178</sup> PUB. L. 111-203 (July 21, 2010) §939(e).



A. THE NAIC'S USE OF RATINGS: A CASE STUDY IN  
REGULATORY OUTSOURCING

1. The "Filing Exempt" Rule

The NAIC adopted the "filing exempt" rule ("FE Rule"), effective January 1, 2004.<sup>179</sup> The Rule provides that bonds and preferred stock that have a current, monitored rating by an NRSRO do not have to be filed with the NAIC's Securities Valuation Office.<sup>180</sup> In effect, the Rule permits insurers to decide to delegate the SVO's credit assessment function to the credit rating agencies, at least for issues that the agencies decide to rate. If an insurer chooses to have the issue rated by the SVO, the insurer must pay a fee.<sup>181</sup>

Unsurprisingly, insurers prefer to use rating agencies: They use ratings from the rating agencies rather than the SVO for about 80% of their holdings,<sup>182</sup> and SVO personnel confirm that insurers use SVO ratings primarily when the rating agencies do not issue ratings on the instrument in question.<sup>183</sup>

It appears that the NAIC adopted the Rule in response to concerns that the SVO did not have the funding to conduct high-quality credit analysis for the entire universe of bonds held by insurers. An NAIC-commissioned 1998 report by KPMG Peat Marwick concluded that the "SVO has difficulty completing an in-depth analysis on the more complex non-rated issues that due to the large volume of submissions it receives, as well limited, qualified, trained staff available to perform the analyses."<sup>184</sup> The consultants found that there was "a need to either change the mission of the SVO and perform much less credit analysis, or to update its standards and dramatically increase its resources to improve the quality of credit analysis performed."<sup>185</sup>

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<sup>179</sup> National Association of Insurance Commissioners, *Understanding the NAIC Filing Exemption Rule*, *supra* note 5758, at 1.

<sup>180</sup> *Id.*

<sup>181</sup> *Id.* at 1-2.

<sup>182</sup> See Evangel, *supra* note 61, at 11 (percentage computed by author).

<sup>183</sup> Interview with Chris Evangel, Managing Director, Sec. Valuation Office (June 29, 2010).

<sup>184</sup> PEAT MARWICK, KPMG, REPORT ON REVIEW OF DUE DILIGENCE PRACTICES AND PROCEDURES OF THE SECURITIES VALUATION OFFICE 2 (June 1998) [hereinafter SVO REVIEW].

<sup>185</sup> *Id.* at 2.

As between those two choices, KPMG recommended the former, arguing that there was “little opportunity for the SVO to add value by conducting detailed independent credit reviews where an NRSRO or insurance company has, or should have, already undertaken such analysis.”<sup>186</sup> For rated securities, KPMG recommended that the NAIC rely on the credit rating to assign the security to one of the six categories;<sup>187</sup> for unrated securities, KPMG recommended that the NAIC “accept the ratings assigned by insurers,”<sup>188</sup> at least as to insurers that “comply with a comprehensive set of credit rating criteria, credit rating procedures and related documentation.”<sup>189</sup> In 2000, the NAIC took one step in the direction the consultants recommended; it adopted a provisional exemption under which corporate and municipal securities that received high ratings from credit rating agencies no longer had to be filed with the SVO.<sup>190</sup> In 2004, with the adoption of Rule FE, the exemption became permanent and was expanded to all bonds and preferred stock rated by recognized rating agencies.<sup>191</sup>

## 2. Reexamination of Rating-Dependent Regulation in the Financial Crisis of 2007-09

The financial crisis and the attendant criticism of ratings provided an occasion for NAIC to reconsider whether to strengthen the role of SVO and reduce that of private credit rating agencies.<sup>192</sup> In February 2009, the NAIC empaneled a Rating Agency Working Group (“RAWG”) to reexamine the use of private credit ratings in insurance regulation. The list of issues that RAWG was to address began with “the problems inherent in reliance on ratings.”<sup>193</sup> Observers expected that the SVO’s role would be

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<sup>186</sup> *Id.* at 3.

<sup>187</sup> *Id.* at 30.

<sup>188</sup> *Id.*

<sup>189</sup> *Id.*

<sup>190</sup> Chris Evangel, Statement and Testimony Before the NAIC’s Working Group Public Hearing, Nov. 18, 2010.

<sup>191</sup> [National Association of Insurance Commissioners, \*Understanding the NAIC Filing Exemption Rule\*, supra note 58, at 1.](#) [NAIC, \*Understanding the NAIC Filing Exemption \(FE\) Rule \(draft Feb. 25, 2004\)\*, at 1.](#) “Recognized” agencies in this context are those that the SEC has designated “nationally recognized statistical rating organizations.” *Id.*

<sup>192</sup> Vaughan, *supra* note 323, at 14 (U.S. regulators “revisiting their reliance on rating agencies in the risk-based capital system”).

<sup>193</sup> RAWG FINAL REPORT, *supra* note 398, at 1.

upgraded significantly and that the NAIC might even go so far as to set up its own credit rating agency.<sup>194</sup>

The RAWG held a public hearing in September 2009 and produced a draft report in December 2009.<sup>195</sup> After receiving a significant number of comments and revising the draft, the RAWG presented its final report on April 28, 2010.<sup>196</sup> The RAWG summarized its recommendations to regulators as follows:

- “[E]xplore how reliance on ARO ratings can be reduced when evaluating new, structured, or alternative asset classes, particularly by introducing additional or alternative ways to measure risk;”
- “Consider alternatives for regulators’ assessment of insurers’ investment risk, including expanding the role of the NAIC Securities Valuation Office;” and
- “[T]ake[] into account” “the steps taken by the NRSROs in correcting the causes that led to the recent rating shortfalls.”<sup>197</sup>

The final report’s recommendations reject the complete elimination of rating-dependent regulation recommended by some commenters and apparently embraced by Congress in the Dodd-Frank bill, stating that agency ratings “have a role in regulation.”<sup>198</sup> At the same time, the RAWG does express a commitment to reducing reliance on credit ratings, finding that “NAIC policy on the use of [credit] ratings should be highly selective.”<sup>199</sup>

The RAWG’s specific proposals for changing the use of ratings focus on new and structured products. Consistent with this Article’s recommendation that regulators require a seasoning period before permitting regulatory use of ratings on novel products<sup>200</sup>, the Final Report

<sup>194</sup> See Sean P. Carr, *NAIC Seeks to Form Its Own Rating Agency*, BESTWIRE, Oct. 20, 2008, at 1.

<sup>195</sup> NAIC RATING AGENCY WORKING GRP., *EVALUATING THE RISKS ASSOCIATED WITH NAIC RELIANCE ON NRSRO CREDIT RATINGS – DRAFT FINAL REPORT 6* (Dec. 1, 2009) [hereinafter RAWG EXPOSURE DRAFT].

<sup>196</sup> RAWG FINAL REPORT, *supra* note 398.

<sup>197</sup> *Id.* at 1.

<sup>198</sup> *Id.* at 5.

<sup>199</sup> *Id.*

<sup>200</sup> See *infra* Part VIII.

recommends that the Valuation of Securities Task Force consider whether new investment products “should be ineligible for filing exemption and/or instead be subject to regulatory evaluation.”<sup>201</sup> For structured products, the recommendation is that the NAIC “develop[] alternative methodologies for assessing structured security risks,” and render structured products ineligible for filing exemption “where an alternative method is adopted.”<sup>202</sup> The merits of this approach are discussed more fully in Part \_\_, below.

The decision to focus on new and structured finance ratings in reforming rating dependent regulation apparently reflects recognition that municipal, corporate, and structured finance ratings are not fully comparable,<sup>203</sup> and in particular that agency ratings are more reliable for traditional instruments such as corporate and municipal bonds. Accordingly, the Final Report recommends further study to confirm if use of ratings in solvency regulation should “differ for municipal, corporate and structured securities as general asset classes,”<sup>204</sup> and the Report’s recommendations on municipal bonds contemplate retention of rating-dependent regulation in that context.<sup>205</sup> The distinction also reflects the weight of opinion in the comment letters that the RAWG received.

Such a distinction makes sense not just in light of the immediate history of the performance of novel-product ratings in the financial crisis, but also from a theoretical standpoint. Scholarly treatment of rating agencies has emphasized the importance of reputational capital in giving agencies incentives to issue only high-quality ratings: Agencies arguably would not risk their reputations for high quality by producing low-quality ratings.<sup>206</sup> But no agency has an existing reputation for high quality in rating novel products, so reputation should not be as effective in this

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<sup>201</sup> *Id.* at 6.

<sup>202</sup> *Id.* at 6. The Report also recommends that NAIC continue to “evaluat[e] the merit of an alternative method to determine the NAIC designations to structured securities, in addition to RMBS,” in an apparent reference to the special valuation method NAIC adopted for RMBS. *Id.* at 7.

<sup>203</sup> See RAWG FINAL REPORT, *supra* note 398, at 2-3.

<sup>204</sup> *Id.* at 4.

<sup>205</sup> *Id.* at 4-5.

<sup>206</sup> See, e.g., Fabian Dittrich, *The Credit Rating Industry: Competition and Regulation* 155-54 (July 13, 2007) (unpublished dissertation, University of Cologne); Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 1-2; Gregory Husisian, Note, *What Standard of Care Should Govern the World’s Shortest Editorials?: An Analysis of Bond Rating Agency Liability*, 75 CORNELL L. REV. 411, 426-27 (1990).

context.<sup>207</sup>

There is but lukewarm support for the idea of upgrading the SVO's role in the Final Report. A draft recommended that the NAIC "consider the possibility of establishing an SVO-like entity as a not-for-profit rating agency,"<sup>208</sup> but the Final Report adds the critical qualification "where [rating agency] rating coverage is not adequate."<sup>209</sup> Given that complaints about agency ratings have focused on reliability and quality, rather than "coverage," the Final Report's language seems to signal abandonment of the idea of an NAIC-sponsored rating agency. Enthusiasm for expanding SVO's role also appears to be waning even in areas that would not require NAIC to set up its own rating agency. For example, the draft report called on NAIC to use SVO in developing alternatives to ratings "if supportive of consumer protection objectives,"<sup>210</sup> but the Final Report omits this recommendation.

Momentum is against shifting against eliminating credit ratings in other respects as well. The December 2009 draft recommended that rating agency ratings "should no longer be used to set RBC [risk-based capital] for structured securities," in part because structured securities are vulnerable to market risk and are highly illiquid.<sup>211</sup> The Final Report states instead that NAIC should "develop tools to better address market and liquidity risk in structured securities."<sup>212</sup> The December 2009 draft of the Report grouped some recommendations under the heading "Eliminate or Modify the Filing Exempt Rule";<sup>213</sup> the Final Report's heading is simply "Modify the Filing Exempt Rule."<sup>214</sup>

Although the RAWG's Final Report seems to reject complete elimination of credit ratings from the NAIC's rules, it does signal a desire to reduce the use of credit ratings. It states that NAIC's "policy on the use of ARO [credit] ratings should be highly selective"<sup>215</sup> and identifies ten issues for further study by the NAIC. As of early April 2011, units within NAIC have completed a number of such studies,<sup>216</sup> although it does not

<sup>207</sup> Hunt, *CRAs and the WWCC*, *supra* note 159-148, at 112.

<sup>208</sup> RAWG EXPOSURE DRAFT, *supra* note 475-195, at 6.

<sup>209</sup> RAWG FINAL REPORT, *supra* note 398, at 5. The Final Report also eliminates the term "SVO-like." *See id.*

<sup>210</sup> RAWG EXPOSURE DRAFT, *supra* note 475-195, at 5.

<sup>211</sup> *Id.* at 7-8.

<sup>212</sup> RAWG FINAL REPORT, *supra* note 3938, at 6.

<sup>213</sup> RAWG EXPOSURE DRAFT, *supra* note 1975, at 7.

<sup>214</sup> RAWG FINAL REPORT, *supra* note 398, at 6.

<sup>215</sup> RAWG FINAL REPORT, *supra* note 398, at 5.

<sup>216</sup> *See Proposed Methodology to Assess the Reliability of NRSRO Credit*

appear that further action has been taken.

But even if the NAIC reduces reliance on credit ratings, it may not reduce its reliance on regulatory outsourcing in general: The NAIC does not seem interested in expanding the SVO's role, as discussed above. And in the one area where the NAIC has rejected reliance on ratings – credit assessments for mortgage-backed securities – the NAIC has continued to outsource credit determinations to private entities.<sup>217</sup> The next section takes up why the NAIC and other financial regulators may want to outsource responsibility for credit determinations.

#### B. WHY IS OUTSOURCED REGULATION SO POPULAR?

The NAIC and other financial regulators are reluctant to abandon rating-dependent regulation altogether, and to the extent NAIC is moving away from rating-dependent regulation, the substitute is to have credit risk assessed by private entities that are not rating agencies. This section proposes two explanations for financial regulators' desire to outsource credit-risk determinations.

##### 1. The Desire for Rating-Dependent Regulation Transcends Insurance

The NAIC's experience fits into a broader pattern of regulatory desire to outsource regulatory decisions – in particular, to outsource them to rating agencies. Although the full extent of rating-dependent regulation has never been documented,<sup>218</sup> regulators have incorporated credit ratings in widely varying areas, including the basic capital rules for broker-dealers,<sup>219</sup> some capital rules for banks,<sup>220</sup> deposit-insurance assessments,<sup>221</sup>

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Ratings, Memorandum from Bob Carcano, SVO, to Matti Peltonen, Chair, Valuation of Securities Task Force, Oct. 8, 2010; Analysis of the Performance of NRSRO Credit Ratings and Implications of Default Statistics Associated with NAIC Designations, Memorandum from Bob Carcano and Wes Beal, SVO, to Matti Peltonen, Chair, Valuation of Securities Task Force, Oct. 10, 2010; Alternatives and Supplements to the Use of NRSRO Credit Ratings, Memorandum from Bob Carcano and Wes Beal, SVO, to Matti Peltonen, Chair, Valuation of Securities Task Force, Oct. 8, 2010.

<sup>217</sup> See discussion *infra* Parts VI.A & VI.B.

<sup>218</sup> The most comprehensive survey appears to be JOINT FORUM, BANK FOR INT'L SETTLEMENTS, STOCKTAKING ON THE USE OF CREDIT RATINGS (2009), available at <http://www.bis.org/publ/joint22.pdf>.

<sup>219</sup> See SEC Net Capital Rule, 17 C.F.R. § 240.15c3-1 (2010). It is worth

and limits on the permitted investments of national banks,<sup>222</sup> money market funds,<sup>223</sup> and federal thrifts.<sup>224</sup> Regulators also seem to use high credit ratings as a proxy for the absence of conflicts of interest: the Department of Labor has granted an exemption to ERISA conflict-of-interest rules that permits underwriters to sell structured securities to an ERISA plan to which the underwriter provides services – as long as the securities have high credit ratings and other requirements are met.<sup>225</sup>

Financial regulators other than NAIC have started to act to reduce their reliance on ratings since the beginning of the financial crisis, but progress has been fitful. For example, in summer 2008 the SEC proposed a three-part set of rules that would have sharply reduced the agency's reliance on credit ratings.<sup>226</sup> The SEC tabled most of the reductions in 2009<sup>227</sup> and adopting *new* rules embracing the use of credit ratings in

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noting that the major Wall Street banks were not covered by this particular rule in the period immediately leading up to the crisis. Instead, they had all opted into an alternative capital regulation system that was part of the "Consolidated Supervisory Entity" program. OFFICE OF THE INSPECTOR GEN., U.S. SEC. & EXCH. COMM'N, SEC'S OVERSIGHT OF BEAR STEARN'S AND RELATED ENTITIES: THE CONSOLIDATED SUPERVISED ENTITY PROGRAM iv-v (2008), *available at* <http://www.sec-oig.gov/Reports/Auditsinspections/2008/446-a.pdf>

<sup>220</sup> See 12 C.F.R. Part 3 App. A §§ 3(a)(4)(iii), 3(b), 3(a)(2)(xiii)(C) (2010).

<sup>221</sup> See 12 U.S.C. § 1817(b)(1)(E)(i) (2006); 12 C.F.R. §§ 327.8(i), 327.9(d)(2) (2010).

<sup>222</sup> 12 C.F.R. §§ 1.2-1.3 (2010).

<sup>223</sup> 17 C.F.R. § 270.2a-7 (2010).

<sup>224</sup> 12 C.F.R. §§ 560.40(a)(1)-(2), 560.42 (2010).

<sup>225</sup> Amendment to Prohibited Transaction Exemption (PTE) 2000-58, 67 Fed. Reg. 54,487 (Aug. 22, 2002).

<sup>226</sup> References to Ratings of Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 40,088 (proposed July 11, 2008); Security Ratings, 73 Fed. Reg. 40,106 (proposed July 11, 2008); References to Ratings of Nationally Recognized Securities Rating Organizations, 73 Fed. Reg. 40,124 (proposed July 11, 2008).

<sup>227</sup> In October 2009, the SEC adopted a final rule removing some references to credit ratings from its rules, References to Ratings of Nationally Recognized Statistical Rating Organizations, 74 Fed. Reg. 52,358 (Oct. 9, 2009), but reopened the comment period on the other, more significant, proposed changes. References to Ratings of Nationally Recognized Statistical Rating Organizations, 74 Fed. Reg. 52,374 (Oct. 9, 2009). Separately, the SEC in May 2010 proposed – but has not adopted – a further rule that would eliminate reliance on ratings in determining whether asset-backed securities are "shelf eligible." Asset-Backed Securities, 75 Fed. Reg. 23,328, 23,331 (proposed May 3, 2010).

2010.<sup>228</sup> Only in 2011 – after the Dodd-Frank Act ordered federal financial regulators to remove ratings from their rules – did the SEC once again take up proposals to remove ratings from its rules.<sup>229</sup> Even those proposals, which were still pending as of early April 2011, would not repeal the use of credit ratings in some important areas, such as in calculating the net capital of smaller broker-dealers.<sup>230</sup>

## 2. A Political Explanation: Stakeholder Interests and Rating-Dependent Regulation of Insurance

The leading scholarly approach to understanding insurance regulation is to consider how the various stakeholder groups, including regulators themselves, interact to produce a policy result.<sup>231</sup> Rating-

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<sup>228</sup> See Money Market Reform Final Rule, 75 Fed. Reg. 10,060 (Mar. 4, 2010) (amending 17 C.F.R. § 270.2a-7). The SEC continued to define “Eligible Securities” as those that receive high credit ratings or that are of “comparable quality” to those receiving high ratings. 17 C.F.R. § 270.2a-7(a)(12), 75 Fed. Reg. at 10,110, and requires money-market fund boards to take action when rating agencies downgrade securities below certain levels. 17 C.F.R. § 270.2a-7(c)(7), 75 Fed. Reg. at 10,114. The SEC’s continuing reliance on credit ratings in this context has come in for academic criticism. See William A. Birdthistle, *Breaking Bucks in Money Market Funds*, 2010 WIS. L. REV. 1155, 1185-87 (describing SEC’s continued reliance on rating agencies in the Final Rule as “[p]erhaps the most curious decision of the SEC in response to all that has occurred in the past two years”). The SEC recently proposed eliminating the express references to credit ratings in its money-market rule. See References to Credit Ratings in Certain Investment Company Act Rules and Forms, 76 Fed. Reg. 12,896, 12,897 (March 9, 2011)..

<sup>229</sup> See References to Credit Ratings in Certain Investment Company Act Rules and Forms, 76 Fed. Reg. 12,896 (March 9, 2011); Security Ratings, 76 Fed. Reg. 8,946 (Feb. 16, 2011).

<sup>230</sup> 17 C.F.R. § 240.15c3-1(a)(1), 240.15c3-1(c)(2) (defining net capital and providing that high-rated securities count more toward satisfying net-capital requirement than low-rated ones). The largest broker-dealers all have opted to use an alternative method for net capital that relies on internal models rather than credit ratings. See Charles Whitehead, *Destructive Coordination*, 96 CORNELL L. REV. 323, 343 n.107 (2011). This method continues to be used, although the SEC has been reexamining it in the wake of criticism since the financial crisis. See Mary L. Schapiro, Chairman, SEC, “Testimony Concerning the State of the Financial Crisis Before the Financial Crisis Inquiry Commission,” at 12-13 (Jan. 14, 2010).

<sup>231</sup> See MEIER, *supra* note 23, at 167 (“The political economy of insurance regulation results from a complex interaction of industry groups, consumer



dependent regulation is fairly easy to understand under this approach, because the leading stakeholders – insurers and regulators – have strong incentives to prefer rating-dependent regulation.

The industry has an incentive to support rating-dependent regulation because it does not want to pay for the SVO to perform the function, as discussed above.<sup>232</sup> Certainly, it appears that insurers led the charge to water down the NAIC's draft report calling for reduced reliance on credit ratings.<sup>233</sup> Moreover, insurers may want to benefit from the liability shield of rating reliance: If regulators rely on the ratings, the argument goes, who could fault the industry for doing the same? One might also expect the industry to be more comfortable with the rating agencies' private bureaucracies than the public bureaucracy of NAIC.

On the other hand, if the industry exerts a strong influence on the NAIC, as one leading study concludes,<sup>234</sup> then why is it that insurers show so little interest in keeping the rating function within that organization, where it can be controlled? A partial answer may lie in the availability of

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interests, regulatory bureaucrats, and political elites"); Randall, *supra* note 201, at 670-86 (explaining states' authority over insurance industry and role of NAIC in terms of stakeholder preferences); Schwarcz, *supra* note 910, at 1715 (introducing framework in which industry as regulatory "buyer," regulator as regulatory "seller," and regulatory "regulator" would interact under conditions of regulatory competition).

<sup>232</sup> See *supra* Part IV. A.1 [describing industry reluctance to pay for SVO]

<sup>233</sup> See NAIC PROCEEDINGS – SPRING 2010, at 10-38 to 10-45 (comment letters from American Council of Life Insurers expressing opposition to precipitous repeal of filing exempt rule and taking issue with RAWG draft report's characterization of rating agency performance as overly negative). Another constituency for rating-dependent regulation in the SEC and NAIC cases is the regulated entities themselves. The Securities Industry and Financial Market Association opposed the SEC's proposal to eliminate references to credit ratings in its Net Capital Rule for broker-dealers. See Fed. Reg. 52,377-78 nn.35-36 (Oct. 9, 2009); Fed. Reg. 52,379-81 (Oct. 9, 2009) (the money-market industry criticized the SEC's move away from rating-dependent regulation). The Department of Labor's reliance on ratings in the context of ERISA exemptions for structured products also appears to originate with an industry proposal. Exemptions Allowing Previously Prohibited Transactions Under ERISA and the I.R.C. of 1986, 55 Fed. Reg. 21455-01 (May 24, 1990).

<sup>234</sup> Randall, *supra* note 201, at 669 ("[T]he history of the NAIC suggests . . . a systematic bias in favor of the industry."); Schwarcz, *supra* note 9, at 1763 ("[I]n the aggregate, ordinary 'monopolistic' insurance regulation is more frequently subject to substantial regulatory capture that produces underregulation as opposed to excessive regulation.").

rule bailouts, as discussed below. If the industry can change the rules in midstream on an ad hoc basis<sup>235</sup> when the rating agencies produce results insurers do not like, that reduces the value of paying to maintain the SVO function year in and year out.

State regulators have an incentive to support rating-dependent regulation because it permits them to avoid blame for poor credit determinations<sup>236</sup> without sacrificing broader authority to set general policy.<sup>237</sup> More fundamentally, no real alternative has emerged, as discussed below.<sup>238</sup>

The rating agencies themselves might be expected to support regulatory use of ratings, as this increases demand for their products.<sup>239</sup> Indeed, it has been suggested that rating-dependent regulation is the basis of the rating agencies' business.<sup>240</sup> In fact, the rating industry's position is more complicated. The largest rating agencies, Moody's<sup>241</sup> and Standard &

<sup>235</sup> See *infra* Part IV.

<sup>236</sup> See Geoffrey P. Miller & Gerald Rosenfeld, *Intellectual Hazard: How Conceptual Biases in Complex Organizations Contributed to the Crisis of 2008*, 33 HARV. J.L. & PUB. POL'Y 807, 839 (2010) (identifying "blame avoidance" as a persistent regulatory bias); Richard Scott Carnell, *Regulator's Incentives*, in MAKE MARKETS BE MARKETS 35, 37 (ROOSEVELT INST., ED. 2010) (identifying regulatory incentive to avoid blame by trying to ensure that problems become apparent during successors' tenure).

<sup>237</sup> Compare Randall, *supra* note 201, at 684-85 (arguing that Congress has an incentive to leave insurance regulation in the hands of the states in the context of regulatory changes permitting greater financial services integration: "By preserving the existing regulatory structures, Congress may be able to take credit for modernizing financial services and enhancing the international competitiveness of U.S. firms while avoiding blame for the inevitable problems that will accompany the changes.").

<sup>238</sup> See *infra* Part IV.B.3

<sup>239</sup> See Thomas J. McGuire, Exec. Vice President and Dir., Moody's Corporate Dep't, Ratings in Regulation: A Petition to the Gorillas, Speech at Sec. & Exch. Comm'n (Apr. 28, 1995) (Moody's executive stating that "[f]rom a financial perspective, I believe that regulation has increased the revenues of the rating industry and contributed to the growth" of rating agencies).

<sup>240</sup> See Frank Partnoy, *The Paradox of Credit Ratings*, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 65, 74 (Richard M. Levich et al. eds. 2001).

<sup>241</sup> See Testimony of Raymond M. McDaniel, *Testimony Before the Fin. Crisis Inquiry Comm'n*, 6 (June 2, 2010), available at <http://www.fcic.gov/hearings/pdfs/2010-0602-McDaniel.pdf> (stating that "Moody's has also continuously advocated for the elimination of the regulatory use

Poor's,<sup>242</sup> take the position that regulators should *not* rely on credit ratings in their rules, while the next-tier rating agencies, Fitch<sup>243</sup> and DBRS,<sup>244</sup> are far more sympathetic to rating-dependent regulation. The suspicion arises that competitive position drives the rating agencies' views on this issue: Moody's and S&P seek to protect their position as market leaders, while the smaller agencies see regulatory recognition of their ratings as an opportunity to boost share.<sup>245</sup>

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of ratings"); McGuire, *supra* note 239-42, at 1 ("Moody's . . . recommends that use of ratings be phased out of financial regulation, such that the sole judge of the quality of rating opinions will again be the investors who bear the risks of fixed-income investment.").

<sup>242</sup> Chris Atkins, Letter to the Editor from S&P Vice President of Communications, *Credit Ratings Agencies*, N.Y. TIMES, June 14, 2010, <http://www.nytimes.com/2010/06/15/opinion/1web15ratings.html> ("[W]e emphatically support legislative proposals that use of ratings should not be mandated through government regulation."); Deven Sharma, Letter to the Editor from S&P President, *Why Rating Requirements Don't Make Sense*, WALL ST. J., Jan. 19, 2010 ("We support removing investor rating requirements and believe the market – not government mandates – should decide the value of our work.").

<sup>243</sup> See Fitch Ratings, Inc., *Submitted Statement of Fitch Ratings* (Sept. 24, 2009) reprinted in NAIC PROCEEDINGS – SPRING 2010, at 10-79 to 10-80 ("Ratings have been used constructively in many places in regulation, as they are an important common benchmark. From a regulatory point of view, the question of what would be used in place of credit ratings is rarely answered satisfactorily."); *Reforming Credit Rating Agencies: Hearing Before the Subcomm. On Capital Mkts., Ins., and Gov't Sponsored Enters.*, 111<sup>th</sup> Cong. 17-18 (2009) (statement of Stephen W. Joynt) ("[R]atings have been used effectively in regulation in many places as independent benchmarks – a position that has been supported by many market participants – and we continue to suggest an in depth case-by-case review of any removal to determine whether such a course of action is appropriate. The question of what would replace ratings also remains unanswered – or at least without a thorough understanding of the specific pros and cons, and unintended consequences.").

<sup>244</sup> DBRS also seems to support rating-dependent regulation to a greater extent than Moody's and S&P. See Letter from Mary Keogh, Managing Director, Regulatory Affairs, DBRS to Richard Newman, Bob Carcano & Dan Daveline, NAIC (Jan. 6, 2010), reprinted in NAIC PROCEEDINGS – SPRING 2010, at 10-57 ("DBRS understands that the use of ARO credit ratings by the market increased over time due to the ARO's historical expertise in the field of credit analysis. This expertise was gained through the skills and experience of its credit analysts that takes years to build.").

<sup>245</sup> See Fitch Ratings, Inc., *supra* note 246-43, at 10-80 ("[I]f you eliminate the use of 'NRSRO' ratings in regulation, company and industry participants will

Whatever the agencies' motives, the leading agencies' opposition to rating-dependent regulation seems to have had little effect on insurance regulation specifically. Fundamentally, the agencies have little ability to control how their ratings are used.<sup>246</sup> Moreover, despite general expressions of opposition to rating-dependent insurance regulation,<sup>247</sup> the agencies' recent statements of support for changing the system seem tepid. Moody's statements in opposition to rating-dependent regulation in the recent NAIC proceeding were heavily qualified<sup>248</sup> and S&P's more so,<sup>249</sup> despite the agencies' strong contemporary statements to more general audiences opposing rating-dependent regulation in general.<sup>250</sup>

Consumers, for their part, generally show up as relatively weak stakeholders in studies of insurance regulation, due to their dispersion and the low salience and high complexity of insurance regulation issues.<sup>251</sup> Organized consumer groups do not appear to have had much impact on the use of credit ratings in insurance solvency regulation, although one such group expressed opposition to rating-dependent insurance regulation in the

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likely develop or maintain their own guidelines and use credit ratings anyway. We believe they will default to the largest 'brand name' rating agencies (Moody's and S&P) . . . .".

<sup>246</sup> Letter from Raymond W. McDaniel, President, Moody's Investors Serv. to Jonathan G. Katz, Secretary, Sec. & Exch. Comm'n (July 28, 2003), *available at* <http://sec.gov/rules/concept/s71203/moodys072803.htm> (rating's status as a 'public good' "led to their adoption by various authorities for certain public policy objectives.").

<sup>247</sup> See McGuire, *supra* note 24239, at 8 (NAIC's use of ratings in capital regulation "has inadvertently created a very pernicious set of economic incentives for the rating agency industry").

<sup>248</sup> See David Teicher, *Written Statement of David Teicher, Managing Dir., Moody's Investors Serv. Before the NAIC Rating Agency Working Grp. Meeting*, Sept. 24, 2009, at 9 ("Moody's supports efforts to discontinue or limit the use of ratings in regulation . . . . We also recognize, however, that in light of current market conditions, eliminating or reducing ratings-based criteria should be pursued judiciously . . . .").

<sup>249</sup> See Grace Osborne, *Written Statement of Grace Osborne, Managing Dir. and Lead Analytical Mgr. for N. Amm Ins. Ratings Before the Meeting of the Rating Agency Working Grp. Of the NAIC*, Sept. 24, 2009, at 6 ("[I]f regulators and policymakers choose to incorporate ratings in their rules as benchmarks, the use of additional benchmarks may also be warranted.").

<sup>250</sup> See *supra* notes 214-15.

<sup>251</sup> See Randall, *supra* note 201, at 670-72; MEIER, *supra* note 23, at 139 (describing difficulty in creating a measure of the importance of consumer groups because of the paucity of such groups).

recent NAIC proceeding.<sup>252</sup>

A question that emerges from this analysis is why NAIC ever relied at all on SVO rather than the rating agencies. After all, the analysis above suggests that the balance of stakeholder interests seems to favor rating-dependent regulation overwhelmingly. One possible explanation is that the NAIC solvency program was born in the 1990s in response to a spate of highly publicized insolvencies,<sup>253</sup> so that there was a high premium on demonstrating regulatory independence from industry at that time. As memory faded, the importance of showing independence decreased. NAIC's reliance on credit ratings simply hasn't attracted comparable attention in the current financial crisis,<sup>254</sup> so no comparable need to take action arose.

### 3. A Substantive Explanation: The Need for a Measure of Credit Risk and the Absence of Compelling Alternatives

#### a. *The Need for a Measure of Credit Risk*

I have argued elsewhere that a pure measure of credit risk is appropriate in any "asset-by-asset" capital regulation system.<sup>255</sup> An asset-by-asset system is one in which capital requirements are determined by combining the risks to which each of the regulated firm's assets are subject,

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<sup>252</sup> Birny Birnbaum, *Testimony of Birny Birnbaum, Ctr. for Econ. Justice, Before the NAIC Rating Agency Working Grp.*, Sept. 24, 2009, at 1 ("[S]tate insurance regulators should not be delegating their regulatory responsibilities to private entities, particularly to private entities whose incentives are not aligned with those of the public function."). No consumer groups submitted comments in the NAIC's rating-agency proceeding. See NAIC PROCEEDINGS – SPRING 2010, at 10-37. Although a consumer-group representative participated in the September 24 public meeting, his comments focused exclusively on the RMBS revaluation proposal.

<sup>253</sup> See Danielle F. Waterfield, *Insurers Jump on Train for Federal Insurance Regulation: Is It What They Really Want or Need?*, 9 CONN. INS. L.J. 283, 300-04 (2002) (describing proposals for federal regulation of insurance solvency in response to high-profile failures and such proposals' ultimate failure in response to opposition from industry and state regulators).

<sup>254</sup> See *supra* Part III.C.2.

<sup>255</sup> John Patrick Hunt, *One Cheer for Credit Rating Agencies: How the Market-to-Market Accounting Debate Highlights the Case for Rating-Dependent Capital Regulation*, 60 S.C. L. REV. 749, 775-77 (2009) [hereinafter Hunt, *One Cheer*].

such as the current U.S. insurance and banking capital regulation regimes.

The reason is that there is at least some probability that a firm will not have to liquidate all its assets. That means that a measure of how well the assets will perform if held to maturity is needed, and that entails a measure of credit risk over the life of the assets. The argument may apply with even greater force to insurance companies than to banks, because insurance companies may be more exposed to the risk that an asset will not pay over the long term, and less exposed to the risk that it will have to be sold for a fire-sale price.

After all, “maturity transformation” – long-term lending funded by short-term borrowing – is central to the business model of commercial banks.<sup>256</sup> And investment banks came to rely heavily on short-term borrowing, not necessarily to fund long-term, illiquid assets, but rather to fund short-term assets that were supposed to be liquid. When the market turned so that those were not liquid, disaster ensued.<sup>257</sup>

By contrast, the core business of an insurance company is transferring and pooling risk.<sup>258</sup> If premiums are prepaid, this does not necessarily entail any short-term borrowing. That means that the risk that an insurance company will have to sell large quantities of assets is smaller. This is not to say that insurance companies face no liquidity risk at all. AIG faced a severe liquidity problem, not just in its parent company, but apparently also in its regulated life insurance subsidiaries.<sup>259</sup> And it has been recognized for some time that life insurers that issue policies that accumulate large surrender values can become vulnerable to runs.<sup>260</sup> But it seems that liquidity risk – the great villain of the recent crisis – is a larger concern for banks than for insurance companies.<sup>261</sup> That suggests that credit risk is a relatively bigger problem for an insurance company than a bank.

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<sup>256</sup> See XAVIER FREIXAS & JEAN-CHARLES ROCHET, MICROECONOMICS OF BANKING 4-5 (1997).

<sup>257</sup> See GARY B. GORTON, SLAPPED BY THE INVISIBLE HAND: THE PANIC OF 2007 47-50 (2010) (describing how decreased willingness to accept structured debt as collateral led to asset sales, falling prices, and systemic insolvency).

<sup>258</sup> See JEFFREY CARMICHAEL & MICHAEL POMERLEANO, THE DEVELOPMENT AND REGULATION OF NON-BANK FINANCIAL INSTITUTIONS 81 (2002).

<sup>259</sup> See *supra* note 159 and accompanying text.

<sup>260</sup> See VAUGHAN & VAUGHAN, *supra* note 1, at 274-75.

<sup>261</sup> See GUILLAUME PLANTIN & JEAN-CHARLES ROCHET, WHEN INSURERS GO BUST 2 (2007).

*b. The Absence of Compelling Alternatives*

Federal regulators working on alternatives to credit ratings for bank capital recently told the national media that the absence of strong alternatives to the ratings was a major obstacle to replacing private credit ratings.<sup>262</sup> Although replacing private credit ratings certainly does not appear impossible, each of the alternatives has practical, substantive, or political problems that apparently have not been carefully evaluated.

*i. Alternative 1: Government Provision*

One alternative is government provision of credit ratings. The regulator is supposed to regulate, so why not let it regulate? Observers have been making this point for a long time, and the idea has been gathering some momentum in academic circles recently.<sup>263</sup>

The recent NAIC experience described above is instructive here. The SVO effectively was a government credit rater, and it was perceived as underfunded and heavily reliant on private ratings. Even after the high-profile failure of many private credit ratings, there was little appetite to restore SVO's function. Of course, this case study just describes how events actually did unfold; it certainly does not prove that government credit raters can *never* receive stable, ample funding and do a good job without pressure from trying to please customers who buy or sell financial instruments. But the history, in combination with the stakeholder analysis above, suggests difficulties in creating and sustaining a high-quality government rater throughout market cycles. Indeed, cyclical rise and decline in regulatory vigor has been identified as a problem for financial regulation generally.<sup>264</sup> It may be difficult for whoever is paying the bills

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<sup>262</sup> See Michael R. Crittenden, *Financial Overhaul Stymies Top Regulators – New Law Might Need Altering Already, as Implementing Its Restrictions on the Use of Credit Ratings Stirs Concerns*, WALL. ST. J., Aug. 11, 2010, at C1 (quoting FDIC Chair Sheila Bair as saying “some of the more likely replacements . . . are far from perfect”).

<sup>263</sup> See, e.g., Lawrence J. White, *The Credit Rating Industry: An Industrial Organization Analysis*, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 41, 41-42, 51-57 (Richard M. Levich et al. eds., 2002); Milosz Gudowski, *Mortgage Credit Ratings and the Financial Crisis: The Need for a State-run Mortgage Security Credit Rating Agency*, 2010 COLUM. BUS. L. REV. 245 (2010).

<sup>264</sup> See, e.g., Erik F. Gerding, *The Next Epidemic: Bubbles and the Growth and Decay of Securities Regulation*, 38 CONN. L. REV. 393, 420-22 (2006).

to continue to see the benefit of replicating over 1 million credit ratings<sup>265</sup> that are otherwise available free after the memory of the most recent crisis has faded.

*ii. Alternative 2: Self-Regulation and  
“Dynamic Risk Modeling”*

A second alternative to rating agencies is self-regulation. This is the core of the Basel II banking regulation framework’s “advanced approaches,” which call for banks to develop internal credit ratings and which base the credit-risk portion of the capital charge on these ratings. Apart from the many criticisms that have been leveled against this approach in the context of banking,<sup>266</sup> and apart from the fact that the continued viability of the Basel II framework is in some doubt, self-regulation is quite dubious as applied to the insurance industry. The fundamental justification for capital regulation is often said to be consumer protection.<sup>267</sup> If the fox is going to put in charge of the henhouse, why bother?

Suggestions that the current system be replaced with dynamic risk-management approaches drawn from quantitative finance seem to fall into the same category.<sup>268</sup> For example, Martin Grace and Robert Klein argue that the existing accounting-based approach is inappropriately “backward-looking” and argue that it should be replaced with a “forward-looking” approach based on such techniques. Because the present system is based on accounting numbers, it allegedly embodies a “static approach” based on

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(describing deregulatory pressures imposed by upward stage of cycles of macroeconomic activity and investor trust); Richard Scott Carnell, *Regulator’s Incentives*, in *MAKE MARKETS BE MARKETS* (Roosevelt Inst. ed., 2010), 35, 36-37 (arguing that the “dynamics of interest-group politics” help explain why regulators fail to strengthen regulatory standards during an economic boom).

<sup>265</sup> This is the number of credit ratings maintained by the two largest private credit rating agencies. See Sec. & Exch. Comm’n, *Annual Report on Nationally Recognized Statistical Rating Organizations* 9 (2009), <http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0909.pdf>.

<sup>266</sup> See, e.g., Erik F. Gerding, *Code, Crash, and Open Source: The Outsourcing of Financial Regulation to Risk Models and the Global Financial Crisis*, 84 WASH. L. REV. 127, 186-89 (2009).

<sup>267</sup> See *supra* notes 14-15 and accompanying text.

<sup>268</sup> See Martin F. Grace & Robert W. Klein, *Insurance Regulation: The Need for Policy Reform*, in *THE FUTURE OF INSURANCE REGULATION IN THE UNITED STATES* 117, 118-19 (Martin F. Grace & Robert W. Klein eds., 2009).



“historic, reported” values and does not “look forward to consider how an insurer might fare under future scenarios.”<sup>269</sup> They couple this argument with a call for “principles-based” regulation as practiced in the E.U., rather than the “rules-based” regulation that state regulators in the U.S. employ.<sup>270</sup> Although this risk management approach enthralled Alan Greenspan,<sup>271</sup> its theoretical foundations have been attacked by Nicholas Taleb<sup>272</sup> and others.

Setting aside the theoretical debate, this kind of dynamic risk management approach seems inextricably tied to self-regulation. Certainly, Grace & Klein conclude that “[d]ynamic modeling is best performed by each insurer, using an internal model subject to regulatory review.”<sup>273</sup> Given the complexity of such approaches, it is difficult to see how regulators could implement it without extensive reliance on the regulated parties’ judgments of risk.

### *iii. Alternative 3: Market-Based Regulation*

Another leading alternative to rating-dependent regulation is market-based regulation. One might simply look at credit spreads – that is, at market prices – to assess credit risk.<sup>274</sup> The problem here, as I have argued at length elsewhere,<sup>275</sup> is that market prices result from the interaction of many different factors, not just credit risk. Credit risk cannot simply be read off a price chart. Although market prices undoubtedly can be useful inputs into any assessment of credit risk – whether performed by rating agencies, regulators, or someone else, market-based regulation is not an independent alternative to rating-dependent regulation.

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<sup>269</sup> *Id.* at 121–22.

<sup>270</sup> *Id.* at 118, 120.

<sup>271</sup> See Alan Greenspan, Chairman, Fed. Reserve Bd., Remarks at the 2003 Conference on Bank Structure and Competition, (May 8, 2003) (“The use of a growing array of derivatives and the related application of more-sophisticated methods for measuring and managing risk are key factors underpinning the enhanced resilience of our largest financial intermediaries.”).

<sup>272</sup> NASSIM NICHOLAS TALEB, *THE BLACK SWAN: THE IMPACT OF THE HIGHLY IMPROBABLE* 274–85 (2007).

<sup>273</sup> Grace & Klein, *supra* note 240, at 127.

<sup>274</sup> Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH U.L.Q. 619, 624–25 (1999).

<sup>275</sup> Hunt, *One Cheer*, *supra* note 228, at 772–75.

*iv. Alternative 4: Private Providers That  
Are Not Credit Rating Agencies*

A final alternative, one that NAIC has embraced in the context of RMBS as described in further detail below,<sup>276</sup> is the idea of having credit assessments for regulatory purposes be provided by private entities that are not rating agencies. A threshold question is whether this is truly an “alternative” at all. After all, regardless of whether a credit rating agency such as Moody’s or a non-credit-rating-agency analytical organization such as PIMCO Advisory or BlackRock is performing the credit analysis, the regulator is outsourcing its decisions to a private third party.

Putting that question to one side, the decision to employ private non-agency credit assessors may respond to either or both of two criticisms of credit rating agencies and their ratings. First, credit ratings embody the agency’s determination in a single three-letter symbol on an ordinal scale. A “BBB” rating on an instrument tells the user only that the agency thinks that an instrument has more “credit risk” than an “A” instrument and less “credit risk” than a “BB” instrument. The rating does not give a quantitative estimate of any aspect of risk. Moreover, exactly what is captured in “credit risk” may vary from agency to agency. For example, Standard & Poor’s main credit ratings are based on the instrument’s probability of default, without taking into account how much the instrument is likely to lose if it does default. Moody’s ratings take both probability of default and loss in the event of default into account, but the firm does not specify how these factors are weighted in general.

Alternative risk assessments offer the possibility of quantitative and much more detailed estimates of credit risk. For example, such an assessment might state that there is a 40% chance of default and an expected 20% loss in the event of default. Or they might state that there is a 10% chance of a default resulting in a 60% loss and a 30% chance of a default resulting in a 7% loss.

Although these more precise and detailed assessments might well be useful, particularly in constructing numerical capital requirements, the difference between this type of assessment and what the rating agencies provide is superficial. There is no reason in principle why rating agencies cannot provide such information, and the agencies have started to offer separate “recovery ratings,” which reflect the likely severity of default, in addition to their main credit ratings on many instruments.

The second major reason for favoring alternative providers is that

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<sup>276</sup> See discussion *infra* Parts VI.A-B.

there may be some difference between an alternative provider and a credit rating agency that suggests that the alternative provider will do a better job. Certainly, some companies may produce better products than others, but it seems odd to assume *ex ante* that, say, PIMCO Advisory will do a better job than, say, Moody's without evidence to this effect unless there is a fundamental structural difference that supports that assumption.

The issuer-pays conflict might be such a difference. If alternative providers are paid by the regulator for high-quality ratings, then they don't face the conflicts of interest that raters that are paid by the rating by parties who want high ratings face. The importance of the issuer-pays conflict is a matter of continuing debate and will not be resolved here. But even if we assume that alternative providers have this advantage, it puts them in the same class as the SVO. They are paid by the regulatory system for their ratings, and in the context of insurance that means they are paid by the industry. Apart from the potential conflict of interest that introduces, reliance on alternative providers faces the same problem as reliance on the SVO: insurers are unlikely to continue wanting to pay for credit assessments when rating agencies are doing the job for free.

Even if one were to conclude that alternative private providers are better than rating agencies, there would still be a significant political-economy problem with regulatory reliance on them.

#### C. THE CONFLICT BETWEEN FINANCIAL REGULATION AND RATING-AGENCY REFORM

If regulators have a persistent desire to outsource credit risk assessment regulation to rating agencies or other third parties, then they would be expected to resist legislative mandates to eliminate such regulation. Indeed, there are already signs that regulators are resisting Dodd-Frank in this respect. The Acting Comptroller of the Currency, John Walsh, testified to Congress in February 2011 that "In [the] context of enhanced regulation that Dodd-Frank provides, the absolute prohibition against any references to ratings under Section 939A goes further than is reasonably necessary."<sup>277</sup> Financial regulators' desire to outsource puts

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<sup>277</sup> John Walsh, Acting Comptroller of the Currency, Testimony Before the Senate Committee on Banking, Housing, and Urban Affairs, at 11 (Feb. 17, 2011). *see also* Crittenden, *supra* note 234 (quoting Comptroller of the Currency John Dugan as stating that "[i]t might be worth Congress taking a second look" at its expression of desire to remove private credit ratings from federal financial regulation).

them in conflict with rating-agency reformers, who focus on the perceived negative effects of rating-dependent regulation on the quality of the ratings themselves. Thus, Congress' effort to expunge private credit ratings completely is understandable, if precipitous: If regulators will not purge credit ratings themselves, someone needs to force them to do it or it will not happen.

But state insurance regulators' continued reliance on credit ratings stands to frustrate Congress's purpose to a substantial extent. If rating-dependent regulation gives agencies incentives to rate every product or to give inflated ratings, then retaining rating-dependent regulation for the huge insurer market in credit-risky securities retains those poor incentives to a large extent. The regulatory use of credit ratings stands to become another point of conflict in the ongoing debate over the proper roles of federal and state insurance regulators.

#### 1. Why Rating-Agency Reformers Oppose Rating-Dependent Regulation

Even if ratings are the best available alternative for capital regulators, rating-dependent regulation may still be a problem because of its effect on the quality of credit ratings themselves. The idea is that because issuers or investors need particular credit ratings in order to satisfy regulatory requirements, there is a source of demand for agency ratings that has nothing to do with quality. In the legal academic literature, this line of argument dates to Frank Partnoy's 1999 article *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Rating Agencies*.<sup>278</sup>

The idea that rating-dependent regulation is an important force driving ratings toward low quality initially met with resistance, in particular from authors who believe that rating agencies have significant reputational capital that they would not be willing to risk by producing low-quality ratings.<sup>279</sup> As the years have passed, the movement against rating-dependent regulation has gathered steam,<sup>280</sup> and Section 939A of the Dodd-

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<sup>278</sup> Partnoy, *supra* 246, at 623-24.

<sup>279</sup> See, e.g., Schwarcz, *supra* note 185, at 14-15; Dittrich, *supra* note 185, at 149-55.

<sup>280</sup> See, e.g., Lawrence J. White, *Credit Rating Agencies & Regulation: Why Less Is More*, in MAKE MARKETS BE MARKETS 43 (Roosevelt Inst. ed., 2010); Christian C. Opp et al., *Rating Agencies in the Face of Regulation: Rating Inflation and Regulatory Arbitrage* (2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1540099](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1540099) (presenting

Frank Wall Street Reform and Consumer Protection Act seems to embody a desire to eliminate federal regulatory agencies' dependence on credit ratings.<sup>281</sup> Section 939A requires "each Federal agency" to review their use of credit ratings within one year<sup>282</sup> and to "remove any reference to or requirement of reliance on credit ratings."<sup>283</sup>

Rating-dependent regulation may reduce rating quality not just because it independently reduces agencies' incentives to produce high-quality work, but also because regulatory reliance on ratings is likely to complicate or frustrate *other* efforts to improve rating-agency quality.

For example, the major premise of the 2006 Credit Rating Agency Reform Act is that increased competition will help rating-agency performance,<sup>284</sup> but rating-dependent regulation may cause competition to be *bad* for the market. If issuers just need to get one or two<sup>285</sup> ratings of a certain level to accomplish what they want to accomplish, then competition may take the form of jockeying to give inflated ratings – competition in laxity.<sup>286</sup> Moreover, with rating-dependent regulation, it's not just *issuers* who demand high credit ratings. We would expect *investors* to demand them as well: Higher ratings help regulated investors such as insurance companies and banks in satisfying regulatory requirements, as we saw above.

From the standpoint of increasing rating quality, the argument for reducing regulatory dependence on agency ratings is certainly logical. But an important premise – that rating-dependent regulation is an important force driving rating-agency behavior – has never really been tested. Indeed, only recently have we started to see the first comprehensive surveys that allow us to understand what the extent of regulatory dependence on agency ratings actually is.<sup>287</sup>

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theoretical model indicating that regulatory use of ratings may produce complete breakdown of ratings' informational content under some circumstances).

<sup>281</sup> H.R. Rep. No. 111-517, at 521-22 (2010).

<sup>282</sup> *Id.*

<sup>283</sup> *Id.*

<sup>284</sup> See Credit Rating Agency Reform Act of 2006, S. 3850, 109th Cong. § 2(5) (enrolled bill as passed by Senate and House, Sept. 29, 2006) ("the 2 largest credit rating agencies serve the vast majority of the market, and additional competition is in the public interest.").

<sup>285</sup> See Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U.L.Q. 43, 73 (2004) (discussing importance of "two-rating norm").

<sup>286</sup> See, e.g., Hunt, CRAs and the WWCC, *supra* note , at 136.

<sup>287</sup> See JOINT FORUM, BANK FOR INT'L SETTLEMENTS, STOCKTAKING ON THE USE OF CREDIT RATINGS (2009), available at <http://www.bis.org/publ/joint22.pdf>.

## 2. The Dodd-Frank Bill and the Conflict Between Financial Regulators and Rating-Agency Reformers

Reformers who seek to eliminate ratings from financial regulation enjoyed their greatest success to date in the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 939A of the Act instructs each federal agency “to the extent applicable” to review and remove its rating-dependent regulations.<sup>288</sup> It seems to reflect a Congressional desire to eliminate federal rating-dependent regulation, though the extent to which is actually a command to the agencies do so is open to question. The meaning of “to the extent applicable” is not clear – there is nothing in the statute that expressly makes clear what would make Section 939A applicable or inapplicable. One interpretation would be that Section 939A is “applicable” to all financial regulatory agencies, but agencies who wish to continue using ratings might argue that “to the extent applicable” confers discretion on them in this respect.

Even if a Congressional mandate to eliminate federal rating-dependent regulation in a year is precipitous in light of the discussion above, such a mandate would be understandable from the standpoint of rating-agency reform if regulators have a consistent tendency to want to

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<sup>288</sup> Section 939A provides in its entirety:

(a) Agency Review.—Not later than 1 year after the date of the enactment of this subtitle, each Federal agency shall, to the extent applicable, review—

(1) any regulation issued by such agency that requires the use of an assessment of the credit-worthiness of a security or money market instrument; and

(2) any references to or requirements in such regulations regarding credit ratings.

(b) Modifications Required.—Each such agency shall modify any such regulations identified by the review conducted under subsection (a) to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations. In making such determination, such agencies shall seek to establish, to the extent feasible, uniform standards of credit-worthiness for use by each such agency, taking into account the entities regulated by each such agency and the purposes for which such entities would rely on such standards of credit-worthiness.

(c) Report.—Upon conclusion of the review required under subsection (a), each Federal agency shall transmit a report to Congress containing a description of any modification of any regulation such agency made pursuant to subsection (b).

rely on ratings, whether arising from legitimate if parochial needs, their own biases, or pressures from those they regulate. Simply put, someone has to force them to do it.

But even if the federal agencies cooperate – and early signs suggest they may not – state insurance regulators' continued reliance on credit ratings seems like an important obstacle to improving the market by reducing rating-dependent regulation. This is because insurance companies are such a large segment of the overall bond market: U.S. insurer holdings of nonfinancial corporate bonds are equal to about half the total outstanding principal of such bonds from U.S. issuers; their holdings of municipal bonds are equal to about 15% of the outstanding principal in that market. The U.S. insurance sector currently owns around \$2.2 trillion in corporate bonds;<sup>289</sup> for comparison, the total amount of U.S. nonfarm nonfinancial corporate bonds outstanding as of the first quarter of 2010 was \$4.25 trillion.<sup>290</sup> As of year-end 2008, insurers held \$432 billion in municipal bonds,<sup>291</sup> and the total amount outstanding was \$2.7 trillion.<sup>292</sup>

Thus, even complete elimination of credit ratings from federal regulatory requirements may not have the desired effect on rating-agency incentives. Of course, Congress probably has the power to preempt state regulation of insurance in this area, and the extent to which it should exercise that power is an ongoing subject of debate. Unless Congress retreats from its objective of complete elimination of rating-dependent regulation, or the risk measures the federal regulators are to devise persuade state insurance officials to abandon rating-dependent regulation, this subject promises to become another area of tension in the historically

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<sup>289</sup> Sapna Maheshwari, *Insurers 'Live and Die' with \$2.2 Trillion in Corporate Bonds*, BLOOMBERG BUSINESSWEEK, May 28, 2010, <http://www.businessweek.com/news/2010-05-28/insurers-live-and-die-with-2-2-trillion-in-corporate-bonds.html>.

<sup>290</sup> FED. RESERVE BD., FEDERAL RESERVE STATISTICAL RELEASE Z.1: FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES 65 (June 10, 2010). The cited figures mean that U.S. insurers hold bonds equal in magnitude to about half the U.S. corporate bond market, but don't necessarily imply that insurers own half of U.S. corporate bonds – insurers hold non-U.S. bonds. NAIC's figures tell a similar story: U.S. insurers held \$1.9 trillion in nonfinancial corporate bonds at the end of 2008, when total nonfinancial nonfarm corporate bonds outstanding were about \$3.8 trillion. Evangel, *supra* note 164, at 11.

<sup>291</sup> Evangel, *supra* note 164, at 11.

<sup>292</sup> SIFMA, *Outstanding U.S. Bond Market Debt* (2008), available at [http://www.sifma.org/research/pdf/Overall\\_Outstanding.pdf](http://www.sifma.org/research/pdf/Overall_Outstanding.pdf).  
research/research.aspx?ID=10806.

vexed relationship between state and federal authority over insurance.

## VI. AIG, THE BOND INSURERS, AND SYSTEMIC RISK

The far-reaching effects of the failures of AIG and the bond insurers during the financial crisis challenged the notion that insurers do not pose systemic risk. Credit ratings served a gatekeeping function for both AIG's and the bond insurers' investments in novel products, investments that contributed to their failure. Nevertheless, the New York State Department of Insurance, which has principal responsibility for regulating the bond insurance industry showed even less interest in reducing rating dependence for bond insurers than the RAWG did for the rest of the industry. Instead, it imposed a series of outright bans on risky activities.

If there is tradeoff between safety and conservatism on the one hand and efficiency, dynamism, or innovation on the other, then recognizing previously unrecognized systemic risk pushes the optimal tradeoff toward safety. Although efforts are under way to reduce any systemic risk posed by insurers, the possibility of such a risk nevertheless supports an effort to make certain insurers safer, even if there are costs to doing so. A seasoning requirement for ratings on novel products offers a way of accomplishing this that actually seems less intrusive than the apparently permanent activity bans the New York Department of Insurance has put in place.

### A. THE FAILURES OF AIG AND BOND INSURERS CHALLENGE THE CONSENSUS THAT INSURERS DO NOT POSE SYSTEMIC RISK

Until the financial crisis, the prevailing view was that insurance companies did not pose a systemic risk. Two leading commentators summed up the conventional wisdom in 2005: "Systemic risk has not been a major preoccupation of insurance regulators, and there has been no evidence of the failure of an insurance company being a significant source of systemic risk."<sup>293</sup> This viewpoint makes a good deal of sense. As discussed above, insurance companies generally do not rely on short-term funding to the same extent banks do, so they are less vulnerable to panics

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<sup>293</sup> Richard Herring & Til Schuermann, *Capital Regulation for Position Risk in Banks, Securities Firms, and Insurance Companies*, in CAPITAL ADEQUACY BEYOND BASEL 15, 23 (Hal S. Scott ed. 2005).



and bank runs.<sup>294</sup> Moreover, the consequences of panics are likely to be less severe: Unlike banks, insurance companies do not operate the payment system. Nor do they originate many loans.

But the failures of AIG and the bond insurers in the financial crisis seemed to create or threaten systemic consequences. Major banks had large exposures to AIG through its CDS activities and lending operations. The bond insurers' difficulties apparently increased uncertainty about the novel products they insured and therefore deepened the problems of the institutions that owned those products. Moreover, bond insurers' problems apparently contributed to liquidity problems in the municipal bond market and interfered with municipalities' ability to borrow, because many municipal bond issues depended on bond insurance coverage. The proposition that the failures actually created a systemic risk is still disputed,<sup>295</sup> and it is true that some of the more damaging exposures were taken on by insurance-company affiliates rather than regulated insurers. But the idea that capital-regulated insurance companies pose a systemic risk can no longer be dismissed out of hand.

# 1. AIG

The perception that the insurance group AIG was

<sup>294</sup> *Id.* at 24.

<sup>295</sup> See MARY A. WEISS, SYSTEMIC RISK AND THE U.S. INSURANCE SECTOR 2 (2010), *available at* [http://www.naic.org/documents/cipr\\_weiss\\_systemic\\_risk\\_100223.pdf](http://www.naic.org/documents/cipr_weiss_systemic_risk_100223.pdf) (“[T]he analysis suggests that insurers are not instigators or the cause of systemic risk”); THE GENEVA ASS’N, SYSTEMIC RISK IN INSURANCE: AN ANALYSIS OF INSURANCE AND FINANCIAL STABILITY 4 (2010), *available at* [http://www.genevaassociation.org/Portals/0/Geneva\\_Association\\_Systemic\\_Risk\\_in\\_Insurance\\_Report\\_March2010.pdf](http://www.genevaassociation.org/Portals/0/Geneva_Association_Systemic_Risk_in_Insurance_Report_March2010.pdf) (“Applying the FSB [Financial Stability Board] criteria to the main activities of insurers and reinsurers, we conclude that none pose a systemic risk”); BRUNNERMEIER ET AL., *supra* note 16, at 24 (classifying insurance companies as “non-systemic large and not highly levered” institutions); Charles Goodhart, *Procyclicality and Financial Regulation*, 16 BANCO DE ESPAÑA INFORME DE ESTABILIDAD FINANCIERA 11, 15 (2009) (same). These analyses are not altogether consistent. For example, Brunnermeier and Goodhart both seem to assume that life insurance companies are not leveraged. See BRUNNERMEIER ET AL., *supra* note 16, at 24; Goodhart, *supra*, at 15. But Weiss’ examination of data leads her to conclude that life insurers’ leverage is comparable to that of commercial banks. See Weiss, *supra*, at 30. She does find that “[p]roperty-casualty insurers are much less highly leveraged than either life-health insurers or banks”). *Id.*

“systemically important”<sup>296</sup> was the articulated basis for the U.S. government’s decision to put at least \$182.5 billion<sup>297</sup> at risk starting in September 2008 to save the firm from disorderly failure.

The perception seems to have stemmed primarily from CDS positions taken by AIG’s trading subsidiary, AIG Financial Products Corp., which had sold credit protection to major banks on a large volume of multi-sector CDOs, many of which were exposed to subprime mortgages.<sup>298</sup> AIG Financial Products Corp. is not an insurance company and is not subject to solvency regulation as described in this Article.<sup>299</sup>

Although regulators have been adamant that AIG’s regulated life insurance companies did not face a solvency threat,<sup>300</sup> these entities did

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<sup>296</sup> See Press Release, Board of Governors of the Federal Reserve System and U.S., Dep’t of the Treasury, U.S. Treasury and Federal Reserve Board Announce Participation in AIG Restructuring Plan (March 2, 2009) (announcing aid to AIG “in order to stabilize this systemically important company”); see also Brady Dennis, *Bernanke Blasts AIG for ‘Irresponsible Bets’ That Led to Bailouts*, WASH. POST, March 4, 2009 (quoting Federal Reserve Chairman Ben Bernanke as testifying to Senate committee, “[W]e’re not doing this to bail out AIG or their shareholders, certainly. We’re doing this to protect our financial system and to avoid a much more severe crisis in our global economy.”).

<sup>297</sup> William K. Sjostrom, *The AIG Bailout*, 66 WASH. & LEE L. REV. 943, 945, 975 (2009).

<sup>298</sup> See *id.* at 959, 979-81.

<sup>299</sup> See American International Group: Examining What Went Wrong, Government Intervention, and Implications for Future Regulation; Testimony to the U.S. Sen. Comm. On Banking Housing, and Urban Affairs, March 5, 2009, at 3 (Statement of Eric Dinallo, Superintendent, New York State Ins. Dep’t, “AIG Financial Products is not a licensed insurance company. It was not regulated by New York State or any state.”; Dennis, *supra* note 264, (quoting Bernanke, “There was no oversight of the Financial Products division. This was a hedge fund, basically, that was attached to a large and stable insurance company....”).

<sup>300</sup> See Sjostrom, *supra* note 266, at 978; *causes and Effects of AIG Bailout: H. Comm. On Oversight and Gov’t Reform*, 110th Cong. 2 (2008) (written testimony of Eric Dinallo, Superintendent of Insurance, New York State Ins. Dep’t). available at

[http://oversight.house.gov/index.php?option=com\\_content&task=view&id=3375&Itemid=2](http://oversight.house.gov/index.php?option=com_content&task=view&id=3375&Itemid=2). (stating that New York regulated insurance companies were solvent). Certainly, insurance regulators have been adamant that policyholders were not at risk. See Dinallo, New York State Ins. Dep’t, Testimony to the U.S. Sen. Comm. on Housing, Banking & Urban Affairs, March 5, 2009, at 6 (“[E]ven if there had been a run on the securities lending program with no federal rescue, our detailed analysis suggests that the AIG life insurance companies would not have been insolvent.”); Joel Ario, Insurance Comm’r, Pennsylvania Ins. Dep’t, Testimony of

experience difficulty as counterparties in securities lending transactions demanded the return of cash collateral, which apparently would have been difficult to accomplish because much of the collateral had been invested in highly rated mortgage-backed securities<sup>301</sup> which had declined in value and couldn't readily be sold.<sup>302</sup> These counterparties were in many cases important financial intermediaries,<sup>303</sup> so this modern-day bank run could have had systemic consequences.

State insurance regulators argue that the threat to AIG's life insurers and the financial system would never have arisen if the company's CDS losses hadn't sparked a bank run.<sup>304</sup> The AIG life insurers' securities-lending troubles may have been a matter of liquidity rather than solvency,<sup>305</sup> although this is disputed.<sup>306</sup> The evidence suggests – although

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the NAIC Before the Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enters., U.S. House of Reps., March 18, 2009, at 6, 11.

<sup>301</sup> Dinallo, *supra* note 269, at 5 (AIG's securities lending program investments were "almost exclusively in the highest-rated securities" and mortgage-backed securities made up "60 percent of the collateral pool."); Ario, *supra* note 269, at 10 (29% of AIG collateral pool was composed of subprime MBS).

<sup>302</sup> Sjöström, *supra* note 266, at 961-62. It is not clear what prevented AIG from selling the securities returned to in the unwind of the lending transactions, as these apparently were government bonds, which remained liquid throughout the crisis.

<sup>303</sup> Press Release, American Int'l Group, Inc., AIG Discloses Counterparties to CDS, GIA, and Securities Lending Transactions, Att. D. (March 15, 2009), (disclosing fourth-quarter 2008 payments of \$1 billion or more from direct Fed support to securities lending counterparties Barclays, Deutsche Bank, BNP Paribas, Goldman Sachs, Bank of America, HSBC, Citigroup, Dresdner Kleinwort, Merrill Lynch, UBS, and ING).

<sup>304</sup> See Dinallo, *supra* note 269, at 4 ("If there had been no Financial Products unit and only the securities lending program as it was, we would not be here today"); Ario, *supra* note 269, at 8 ("[S]ecurities lending did not pose unmanageable systemic risk and was not the reason for federal intervention. AIG Financial Products was the source of federal intervention.").

<sup>305</sup> Dinallo, *supra* note 269, at 6 (absent "run on the securities lending program," regulators "would have continued to work with AIG to unwind its program and any losses would have been manageable ... [E]ven if there had been a run on the securities lending program with no federal rescue, our detailed analysis indicates that the AIG life insurance companies would not have been insolvent.").

<sup>306</sup> See Scott E. Harrington, *The Financial Crisis, Systemic Risk, and the Future of Insurance Regulation*, Sept. 2009, at 11, available at [www.naic.org/documents/topics\\_white\\_paper\\_namic.pdf](http://www.naic.org/documents/topics_white_paper_namic.pdf).

it does not conclusively establish – that the securities lending activities of AIG’s life-insurance subsidiaries posed a systemic risk.

## 2. Bond Insurers

### a. Industry Background

Bond insurers, also called “financial guaranty insurers” or “monoline insurers,” insure against default losses on debt obligations. As of 2008, the industry accounted for about \$3 billion in direct premiums,<sup>307</sup> and eight firms accounted for about 99% of direct premiums written between 2001 and 2008.<sup>308</sup> The basic premise of the bond insurance industry is that the guaranty insurer maintains very strong credit, so that by insuring a debt obligation it reduces the credit risk on that obligation. The lower credit risk because of the insurance “wrapper” allows the issuer to sell the debt at a lower yield, so that the interest savings at least cover the cost of the insurance premium.<sup>309</sup> How this industry would add value in a truly efficient market is not immediately intuitive, although theoretical arguments based on asymmetric information have been advanced to justify its existence.<sup>310</sup>

The bond insurance business originated in<sup>311</sup> the municipal debt market and continued to be important to that market until the financial crisis. From the mid-1990s until 2008, around half of new municipal bond issuances were covered by bond insurance.<sup>312</sup> Starting in the 1980s, bond insurers expanded into insurance of financial products other than municipal debt.<sup>313</sup> The first expansion was to guarantees of public project finance

<sup>307</sup> See Pamela Drake & Faith Neale: Financial Guarantee Insurance: Arrogance of Ignorance in an Era of Exuberance (Aug. 2009) (unpublished working paper) (on file with author) at 9.

<sup>308</sup> See *id.* at 9-10.

<sup>309</sup> See JAN JOB DE VRIES ROBBÉ, SECURITIZATION LAW AND PRACTICE IN THE FACE OF THE CREDIT CRUNCH 69 (2009).

<sup>310</sup> See Anjan Thakor, *An Exploration of Competitive Signaling Equilibria with “Third Party” Information Production: The Case of Debt Insurance*, 37 J. FIN. 717 (1982).

<sup>311</sup> See James P. McNichols, *Monoline Insurance and Financial Guaranty Reserving* 231, 233 (2003) available at [www.casact.org/pubs/forum/03ffforum/03ff231.pdf](http://www.casact.org/pubs/forum/03ffforum/03ff231.pdf).

<sup>312</sup> See Drake & Neale, *supra* note 276, at 30 Fig. 2.

<sup>313</sup> See *id.* at 276, at 25 Tbl. 1; Circular Ltr. 19, at 2.

bonds, starting in the late 1980s.<sup>314</sup> Later, bond insurers began to take on credit risk associated with more novel and complex financial products. They insured notes issued by CDOs,<sup>315</sup> created special purpose vehicles to sell credit protection on CDOs by entering into credit default swaps,<sup>316</sup> and invested in CDOs.<sup>317</sup> This activity eventually grew to account for a large proportion of the bond insurers' business.<sup>318</sup>

*b. Industry Failure and Systemic Effects*

As described in greater detail above, downgrades, collateral calls, and defaults on novel financial products led to severe financial problems for the bond insurers.<sup>319</sup> Losses that call solvency into question are, of course, significant for any insurer, but superior credit is by definition the stock in trade of financial guaranty insurers. Bond insurers operated with high leverage to begin with because of the perceived safety of their exposures, and the financial crisis caused most bond insurers to suffer serious rating downgrades and to be unable to meet regulatory capital

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<sup>314</sup> See Bartlett, *supra* note 152, at 9.

<sup>315</sup> See *id.* at 9.

<sup>316</sup> See Drake & Neale, *supra* note 276, at 6 (outstanding notional value of monoline CDS was \$550 billion as of March 2008)

<sup>317</sup> See *id.*, at 17.

<sup>318</sup> Drake & Neale report that structured finance "compris[ed] up to half the insurance portfolio of several [financial guaranty] insurers." *Id.* at 6.

<sup>319</sup> See, e.g., Helen Remeza, *Financial Guaranty Insurance Industry 2009 Review and 2010 Outlook*, MOODY'S SPECIAL REP., at 2 (Feb. 2010) (Moody's report asserting that financial guaranty insurers saw their resources "severely depleted as a result of claims, mostly from direct mortgage exposures and leveraged exposures through ABS CDOs, but also through stress in their insured asset-management business."). Although the extent of financial insurers' exposure to actual default losses on insured novel products is not clear, and although it is argued that prices on such instruments during the crisis were reduced below fair value due to market liquidity issues and investor panic, Bartlett documents the existence of actual losses on highly rated notes issued by CDOs and insured by monoline insurers. See e.g., Robert Bartlett III, *Inefficiencies in the Information Thicket: A Case Study of Derivative Disclosures During the Financial Crisis* at 48-49 (2010) available at <http://www.ssrn.com/abstract/=1585953> (liquidation of Kleros Preferred Funding VI Ltd. CDO in late 2009 resulted in a \$2 billion principal deficiency on \$2.4 trillion of Class A-1S notes insured by Ambac). The Class A-1S notes carried an initial rating of AAA. See Kleros Preferred Funding VI Ltd. Offering Circular at 1, (June 6, 2007) available at [http://www.ise.ie/debt\\_documents/kleros\\_5756.pdf](http://www.ise.ie/debt_documents/kleros_5756.pdf)

requirements.<sup>320</sup> By 2010, only one bond insurer was writing new business.<sup>321</sup>

The failure of the bond insurers naturally affected their counterparties and the markets for the products they insured. The failure of CDS and insurance policies on novel products seems to have imperiled the bond insurers' counterparties in the same way AIG's failure might have.<sup>322</sup> The fact that the insurance coverage for such exposures had been called into question presumably increased uncertainty and decreased confidence, further reducing liquidity for RMBS and CDOs. Even municipal bonds, historically seen as quite safe, were seriously affected. Prices plunged and municipalities reportedly found it difficult to issue debt.<sup>323</sup>

B. Rating-Dependent Regulation of Bond Insurance and Systemic Risk

The experience of the financial guaranty insurance industry illustrates the problems with rating-agency gatekeeping of insurance-company exposures. The exposures in this case arose from the bond insurers' decisions to invest in novel products, and even more importantly from their decision to insure novel assets in various ways. The financial guarantors were allowed to insure novel products because rating agencies had given those products investment-grade ratings.

The regulatory response to the state of the FGI industry did not seriously question rating-dependent regulation, providing yet another example of regulators' reluctance to abandon ratings altogether. In fact, the New York State Department of Insurance *increased* its reliance on credit ratings, and its efforts to prevent recurrence of the FGI industry's plight took the form of outright, apparently permanent bars on certain FGI activities. Here again, a seasoning requirement for giving regulatory effect to credit ratings would have averted the problem – a problem that in this case apparently contributed to systemic crisis. Moreover, a seasoning requirement would be *less* intrusive in some respects than the approach the

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<sup>320</sup> Remeza, *supra* note 288, at 3.

<sup>321</sup> *See id.* at 2.

<sup>322</sup> *See, e.g.,* Bartlett, *supra* note 288 at 51 (“Like AIG Financial Products, monoline insurers stood at the center of the Financial Crisis in light of their key role insuring the super-senior tranches of multi-sector CDOs tied to residential mortgages.”).

<sup>323</sup> *See* Marc Levinson, *Financial Regulation's Fatal Flaw* COUNS. OF FOREIGN AFF. (Jan. 21, 2010), *available at* [http://www.cfr.org/publication/21263/financial\\_regulations\\_fatal\\_flaw.html](http://www.cfr.org/publication/21263/financial_regulations_fatal_flaw.html).

Department of Insurance eventually adopted.

### 1. Pre-Crisis Rating-Dependent Regulation of Bond Insurers

Credit risk is central to the financial guaranty insurance industry. Credit risk doesn't just affect the performance of the guarantors' investments; it also determines the amount they are required to pay out in claims. Unsurprisingly, credit ratings come up frequently in discussions of the industry.

A bond insurer's credit rating is important to its business. One recent study declares that "the value of a monoline financial guarantee insurer is directly tied to its credit rating."<sup>324</sup> This is probably due in large part to the fact that certain obligations that New York-regulated insurers otherwise cannot purchase can become eligible for investment if they are covered by bond insurance – but only if the bond insurer maintains a AAA rating.<sup>325</sup>

The credit ratings of individual instruments are central to the regulation of bond insurers. The New York State Department of Insurance apparently is the most important capital regulator for financial guaranty insurers,<sup>326</sup> and New York's pre-crisis solvency rules for financial guaranty insurers were heavily rating-dependent:

*Policyholders' surplus:* Financial guaranty insurers must maintain a policyholder's surplus (excess of admitted assets over liabilities)<sup>327</sup> of \$65 million.<sup>328</sup> Only specified types of assets can be used to satisfy this

<sup>324</sup> Drake & Neale, *supra* note 276, at 21; *see also* McNichols, *supra* note 280, at 257 ("the monoline's highest priority is maintenance of its AAA ratings").

<sup>325</sup> N.Y. INS. LAW § 1404(a)(2)(iii) (McKinney 2006).

<sup>326</sup> It appears that even when financial guaranty insurers are domiciled in states other than New York, the state of domicile will look to New York for capital standards. *See, e.g.,* Office of the Comm'r of Ins., State of Wisconsin, *Report of the Examination of Ambac Assurance Corporation* (Aug. 31, 2007), at 34-35 (noting that Wisconsin-domiciled Ambac "is also subject to the minimum capital requirements of the New York Insurance Laws, which are more restrictive than Wisconsin requirements for certain segments of the financial guaranty business. The New York aggregate risk limitation requirement serves as an industry standard for the evaluation of minimum capital requirements of a financial guaranty insurer and is used as the minimum standard in Wisconsin.").

<sup>327</sup> N.Y. INS. LAW § 107(a)(42) (McKinney 2006).

<sup>328</sup> *Id.* § 6902(b)(1). (McKinney 2009) The New York State Department of Insurance stated in 2008 that it would seek to increase this "to a figure in excess of

requirement,<sup>329</sup> and one of those types is municipal bonds – as long as they carry high ratings.<sup>330</sup>

*Contingency reserves:* Financial guaranty insurers must maintain contingency reserves to cover losses on insured instruments. For bonds other than municipal obligations and special revenue bonds, the amount of the required contingency reserve depends on the credit rating of the insured instrument: Insurers must hold 1-1.5% of guaranteed principal against investment-grade obligations,<sup>331</sup> and 2-2.5% of guaranteed principal against non-investment grade obligations,<sup>332</sup> where “investment grade” is a rating-dependent determination.<sup>333</sup>

*Aggregate risk limitations:* Financial guaranty insurers must maintain surplus to policyholders and contingency reserves<sup>334</sup> against the unpaid principal, interest, and other obligations of guaranteed obligations, net of reinsurance ceded and collateral.<sup>335</sup> The amount of surplus and reserves that has to be held against an insured obligation under this rule generally depends on the obligation’s rating. For example, the insurer must hold reserves and surplus equal to 1-1.5% of the insured amount of most investment-grade obligations<sup>336</sup> and 2-4% of the insured amount of most non-investment-grade obligations.<sup>337</sup>

*Overall investment-grade limit:* At least 95% of the insurer’s aggregate net liability on municipal obligation bonds, special revenue bonds, and industrial revenue bonds must be on investment-grade

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\$150 million.” Circ. Ltr. No. 19, at 10, available at [http://www.ins.state.ny.us/circltr/2008/c108\\_19.htm](http://www.ins.state.ny.us/circltr/2008/c108_19.htm).

<sup>329</sup> See N. Y. INS. LAW § 1402 (McKinney 2006) (setting forth general rules for what assets can be used to satisfy policyholders’ surplus requirement)

<sup>330</sup> See N. Y. INS. LAW (McKinney 2009) § 6902(b)(3).

<sup>331</sup> *Id.* § 6903(a)(4)(B)(i)-(ii).

<sup>332</sup> *Id.* LAW § 6903(a)(4)(B)(iii)-(v)

<sup>333</sup> *Id.* § 6901(n) (investment-grade obligation is one rated in the “top four generic lettered rating classifications by a securities rating agency acceptable to the superintendent,” identified in writing by such a rating agency to be of investment grade quality, or rated NAIC-1 or -2 by SVO).

<sup>334</sup> *Id.* § 6904(c).

<sup>335</sup> *Id.* § 6901(d) (defining “aggregate net liability” in these terms).

<sup>336</sup> N.Y. INS. LAW § 6904(c)(1)(C)-(D) (McKinney 2009).

<sup>337</sup> *Id.* § 6904(c)(1)(E)-(G). Notably, municipal bonds are subject to the same (low) capital requirement regardless of credit ratings. See *id.* § 6904(c)(1)(A) (requirement to hold 0.333% of principal value of municipal bonds in reserves and surplus).



instruments.<sup>338</sup>

Although the aggregate insurance risk limitations mentioned above could be considered a form of risk-based capital requirement, the New York State Department of Insurance apparently does not impose risk-based capital standards based on exposures.<sup>339</sup>

Bond insurers apparently played a large role in securing acceptance of novel products.<sup>340</sup> Because bond insurers' own ability to take on exposures was rating-dependent, this created an indirect form of rating-dependent regulation. A potential investor that would not or could not invest in a product based on the product's rating might invest based on the bond insurance – insurance enabled by the existence of a rating.

## 2. The New York State Department of Insurance Deepens Its Reliance on Ratings in Response to the Crisis

The failure of bond insurers in the financial crisis has led some commenters to conclude that “[s]olvency procedures currently used by regulators are not sufficient to monitor the solvency of bond insurers, due in part to the lack of risk-based capital standards and the deviation of FGIs away from their core business.”<sup>341</sup>

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<sup>338</sup> *Id.* § 6904(b)(2).

<sup>339</sup> See Drake & Neale, *supra* note 276, at 12-13 & n.45. Drake and Neale report that financial guaranty insurers are all regulated by the State of New York, which has adopted a separate regulatory regime for these insurers that does not incorporate NAIC's risk-based capital guidelines. *Id.*

<sup>340</sup> See Bartlett, *supra* note 288, at 9 (securitized products “typically required some form of external credit enhancement in order for the senior notes ... to receive an investment grade credit rating” and financial guaranty insurers were well positioned to provide enhancement because “no monoline insurer had ever experienced a single ratings downgrade.”); McNichols, *supra* note 280, at 257 (estimating that 1/3 of all asset-backed security transactions are wrapped by AAA insurers); Basel Committee on Banking Supervision, Joint Forum, *Credit Risk Transfer* 21 (March 2005) (“To a great extent, their role appears to be to provide an additional layer of bonded due diligence (beyond that provided by the rating agencies) that enables CDO tranche buyers to become comfortable with purchasing instruments that they themselves are uncertain how to evaluate fully”). On the explosion of novel securitized products, see, e.g., Yongheng Deng et al., *CDO Market Implosion and the Pricing of Subprime Mortgage-Backed Securities* 3-4 (March 2009) (global CDO issuance expanded from \$300 billion to \$2 trillion from 1997 to 2006, subprime asset-backed CDO issuance increased from \$10 billion in 2000 to \$50 billion in 2006).

<sup>341</sup> Drake & Neale, *supra* note 276, at 42.

The New York Department of Insurance has taken action to address such concerns. On September 22, 2008, the Department issued Circular Letter Number 19, which provided new guidance for financial guaranty insurers in response to the declines in the structured-finance market and the rating agency downgrades of the leading bond insurers.<sup>342</sup> Circular Letter 19 did not directly reduce the role of rating agencies. Indeed, New York deepened its commitment to rating-dependent regulation. Circular Letter 19 includes a statement that the Department expects that FGI's entire portfolios will be invested in investment grade assets, with "investment grade"<sup>343</sup> determined by rating. Circular Letter 19 also forbids financial guaranty insurers to insure non-agency CDOs of ABS absent special permission from the Superintendent – or a policy provision that the insurer holds an unsubordinated senior position with a rating of A or better.<sup>344</sup>

By enacting what appears to be a permanent ban on insuring ABS CDOs under certain conditions, Circular Letter 19 imposes a requirement that is more onerous and intrusive than a seasoning requirement would have been.

#### C. IMPLICATIONS FOR REGULATORY REFORM

The difficulties that apparently systemically important regulated insurers faced after highly rated novel products failed to perform as anticipated highlight the importance of rating reliability. The failure of a systemically important institution has important consequences, so if all else is equal, systemically important institutions should be regulated more conservatively than institutions that lack systemic importance. The pre-crisis rating-dependent bond insurance regulations described above did not distinguish appropriately between ratings that could be expected to be highly reliable and those that could be expected to be less reliable. Ratings on financial products with a long history are likely to be more reliable than ratings on novel products. This is true even if the novel-product ratings are as good as anyone has a right to expect,<sup>345</sup> and regulatory conservatism is

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<sup>342</sup> Circ. Ltr. No. 19. Circular Letter No. 19 took effect January 1, 2009.

<sup>343</sup> See *id.* at 9 (the "95% investment grade" rule previously had covered only municipal, special revenue, and industrial development bonds).

<sup>344</sup> *Id.*, at 5.

<sup>345</sup> The same observation applies to the bond insurers' internal assessments of credit risk, which contemporary analysts regarded as first-rate. See Joint Forum, *Credit Risk Transfer* 37 (March 2005) ("At this stage, the Working Group has not

even more strongly indicated if the market cannot fully digest the extent and nature of an insurer's exposures to novel products, as appears to have been the case for the bond insurers.<sup>346</sup>

A seasoning requirement – a determination that ratings will not be given regulatory effect until the rated product has been in existence long enough to permit reliable ratings – is a simple way of achieving regulatory conservatism. It appears less intrusive and restrictive than imposing permanent bars on taking exposures to novel products, as New York's insurance department apparently has done.

## VII. RMBS, RULE BAILOUTS, AND THE LIMITS OF CAPITAL REGULATION

As the RAWG and the New York State Department of Insurance were illustrating the difficulty of abandoning rating-dependent regulation in general, a separate NAIC proceeding was illustrating the difficulty of sticking to rating-dependent regulation – or any *ex ante* capital rules – in the midst of a financial crisis. Rating-agency downgrades of RMBS during the financial crisis would have required insurers to raise large additional amounts of capital under the risk-based capital rules. In response, the NAIC abandoned its rating-dependent rules for RMBS and substituted an alternative third-party credit risk assessor. The NAIC's action resembles the move away from mark-to-market accounting in banking around the same time, which apparently was motivated by a desire to provide capital relief in that sector. Both actions can be described as "rule bailouts" – changes to the rules in the midst of a crisis at the behest of a regulated industry in order to avoid the need to raise capital or be found insolvent.

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found evidence of hidden concentrations of credit risk. Nevertheless, there are some non-bank firms whose primary business model focuses on taking on credit risk. These include the monoline financial guarantors and the specialized CDS entity described above. Other market participants are fully aware of the nature of these firms. In the case of the monolines, credit risk has always been their primary business activity and thus they have invested heavily in obtaining expertise in the analysis of credit risk. The rating agencies also obtain significant data on individual transactions entered into by the monolines. While it is clearly possible that one of these firms could experience unanticipated problems or otherwise misjudge the risks involved, such problems are not likely to be the result of having entered into the business of CRT activity lightly. Given their orientation toward super senior risk, the monolines exhibit more exposure concentration rather than risk concentration.")

<sup>346</sup> See Bartlett, *supra* note 288, at 1-4.

Rule bailouts may be justified on their own terms when they happen. The life insurance industry presented a well-reasoned argument for the change – albeit an argument that did not rest on anything specific to the financial crisis and that could have been raised years earlier. Almost any rule bailout can be characterized either as a justified response to the failure of preexisting rules devised by fallible humans to work in a financial crisis or as an unjustified example of regulatory forbearance – reflecting perhaps the fact that regulators want to believe, along with their regulated charges that things will turn around somehow, or at least that failure can be staved off until a new regulator is on the watch.

Whether any particular rule bailout was justified or unjustified on the merits, the tendency to engage in rule bailouts has implications for the design of capital rules. For example, regulators might consider limiting reliance on rigorous, painful enforcement of existing rules in a financial crisis, which in turn counsels conservative requirements to build up institutions' cushions when a crisis is not occurring. Relatedly, rule bailouts impart a kind of shadow countercyclicality to capital requirements that might be considered in designing a macroprudential regulatory system. High capital requirements are not as procyclical as they might appear if they are likely to be relaxed in crisis. And the unexpected failure of ratings that depended on correlation measures, which triggered the pressure for a rule bailout, suggests that regulators should be cautious in approaching regulatory-reform suggestions that would increase reliance on accurate forecasts of correlation.

The tendency toward rule bailouts is characteristic of capital regulation generally, not just of rating-dependent regulation. But rating-dependent regulation as practiced by insurance regulators helped create the conditions for a rule bailout by making it easy for insurers to amass large exposures to novel assets that performed unpredictably in a financial crisis. A seasoning requirement would have helped avoid that situation. Moreover, a seasoning requirement is less vulnerable to the forces that produce rule bailouts than, say, a requirement that regulators take prompt corrective action to resolve endangered institutions, because the seasoning requirement does not rely on regulators to make painful decisions in the midst of a financial crisis.

#### A. RMBS REVALUATION IN THE CRISIS OF 2007-09

In the wake of the crisis, the NAIC changed its approach to solvency regulation of residential mortgage-backed securities. Instead of relying on agency ratings, NAIC now relies on models developed by

PIMCO Advisory to place each RMBS into one of the six NAIC categories.<sup>347</sup> The RAWG report states that this change, “(1) identifies the actual risks presented by RMBS; (2) quantifies the severity of possible losses; (3) provides a better measure of losses against which surplus must be kept; and (4) when appropriate, frees up capital, in particular for securities held at a discount.”<sup>348</sup>

This decision generally follows a proposal that the American Council of Life Insurers advanced in August 2009 after a wave of downgrades to the credit ratings of RMBS.<sup>349</sup> ACLI argued that the rating-based capital rules required the insurers to hold too much capital.<sup>350</sup> In particular, ACLI argued that agency ratings were based “primarily on the likelihood of the first dollar of loss,”<sup>351</sup> so that the ratings did not “distinguish between securities that are projected to experience a total loss and securities that are projected to experience minor losses.”<sup>352</sup> Thus, a 10% chance of default produced the same rating, regardless of whether the bond was likely to lose 1% or 100% of its value on default. Although Moody’s apparently did not submit formal comments on the ACLI proposal before it was adopted, Moody’s later argued that this was an unfair characterization of its ratings; for securities were expected to incur a loss (usually those rated below B), Moody’s stated it was an unfair characterization because its ratings were based on anticipated recovery.<sup>353</sup> Moody’s also argued that its recovery estimates on subprime RMBS were no lower than those implied by market prices.<sup>354</sup>

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<sup>347</sup> RAWG Final Report, *supra* note 38, at 4.

<sup>348</sup> *Id.* at 4.

<sup>349</sup> Letter from John Bruins, Senior Actuary, Am. Council of Life Insurers (ACLI) & Andrew Melnyk, Managing Director, ACLI to Michael Moriarty, Chair, Valuation of Securities Task Force, NAIC & Lou Felice, Chair, Capital Adequacy Task Force, NAIC (Aug. 10, 2009) (on file with author), *available at* <http://www.naic.org> [hereinafter “ACLI Aug. 10, 2009 Letter”].

<sup>350</sup> *Id.* at 1. (“unwarranted impact on RBC being experienced by the industry” as a result of rating agency RMBS downgrades).

<sup>351</sup> *Id.*, at 1.

<sup>352</sup> *Id.* at 3.

<sup>353</sup> Debash Chatterjee et al., *Moody’s Ratings on U.S. RMBS Reflect Expected Recoveries: Ratings on Impaired Securities Do Not Overstate Risk*, Final Report of the RAWG to the Financial Conditions (E) Committee: Comment Letters 1,2 (Nov. 6, 2009) *available at* [http://www.naic.org/scommittees\\_e\\_rating\\_agency.htm](http://www.naic.org/scommittees_e_rating_agency.htm) (click on “Rating Agency WG Final Report”; then proceed to section 8 of Moody’s pdf),

<sup>354</sup> *Id.* at 2.

ACLI argued that this was inappropriate because the risk-based capital system was calibrated to levels of loss given default typical of corporate bonds, while RMBS were likely to suffer much less loss given default than corporate bonds.<sup>355</sup> Thus it arguably was inappropriate to make an insurer hold as much capital against a B-rated RMBS as against a B-rated corporate bond.

This was a serious issue for the insurers; ACLI cited a report finding that at least 64% of AAA-rated non-agency RMBS had been downgraded to below investment grade by at least one rating agency by June 2009.<sup>356</sup> ACLI estimated the credit-risk capital component of their capital requirement attributable to RMBS increased from \$2 billion as of the end of 2008 to \$11 billion by the end of 2009 as a result of the RMBS downgrades.<sup>357</sup>

ACLI's proposal was adopted with little formal comment; NAIC's records reveal only two official comments, both friendly to the ACLI proposal.<sup>358</sup> The NAIC adopted special rules under which a third-party

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<sup>355</sup> ACLI Sept. 10, 2009 Letter, *supra* note 318, at 4. In particular, ACLI argued that in the event of a corporate default, corporate bond indentures typically terminate interest payments and accelerate maturity of the principal, effectively terminating the security on default. ACLI argued that RMBS structure, by contrast, allow securities to continue receiving principal and interest even after an event of default. *Id.* Thus, ACLI argued, "In the case of senior RMBS tranches, the ability to receive several years of coupon payments alone dramatically improves expected economic recoveries relative to a typical corporate bond." *Id.* ACLI's letters proposing the change in methodology did not present any quantitative data backing this analysis, and it does not appear that any such data was presented in the course of NAIC's consideration of ACLI's proposal.

<sup>356</sup> *Id.* at 3.

<sup>357</sup> ACLI Sept. 10, 2009 Letter, *supra* note 318, at 3. Apparently the actual increase in the amount of capital the industry would have to hold would be somewhat less than the \$9 billion difference between these two numbers because of the way the risk-based capital formula combines the different risks to arrive at a total risk-based capital requirement – a process called "taking correlation into account." See *supra* Part \_\_. For example, if a company had a \$2 billion capital charge for interest rate risk, a \$2 billion capital charge for credit risk, and a \$10 billion capital charge for insurance risk, then total risk-based capital would be around \$10.8 billion. If the credit-risk component of the charge were to increase from \$2 billion to \$11 billion, then total risk-based capital would be \$16.4 billion, an increase of \$5.6 billion, not \$9 billion. The formula guarantees that the increase in total capital will be less than the increase in the credit risk charge unless the company has no insurance risk.

<sup>358</sup> One comment was from a provider of analytical tools for RMBS that would

evaluator would establish a price range for each RMBS for each of the six NAIC designations, and those ranges would be used instead of credit ratings to establish the amount of capital that the insurers were obliged to hold.<sup>359</sup>

The change apparently had the intended effect; NAIC estimated that the change in valuation method reduced the credit-risk capital charge for life insurance companies' RMBS holdings from \$10.8 billion to \$3.5 billion – a 68% reduction.<sup>360</sup>

The rating agencies resisted the notion that their rating downgrades were responsible for the industry's straits. Moody's suggested that most of the reduction in required capital came from the decision to give insurers the benefit of bargain purchases and write-downs, rather than the change in who was doing the assessment.<sup>361</sup> For its part, Fitch pointedly commented that its ratings "are expressly not designed to effect a pre-determined regulatory outcome, such as 'free[ing] up capital.'"<sup>362</sup>

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have been a potential candidate to be hired to carry out the third-party valuation exercise. See Letter from Andrew Davidson, Pres., Andrew Davidson & Co. to Michael Moriarty, Chair, Valuation of Securities Task Force, NAIC, & Lou Felice, Chair, Capital Adequacy Task Force, NAIC (Sept. 30, 2009) (on file with the author) *available at* [http://www.naic.org/documents/committees\\_e\\_091014\\_materials.pdf](http://www.naic.org/documents/committees_e_091014_materials.pdf). The other was from a life insurance company that suggested technical changes to the process for valuing the RMBS. See E-mail from Andy Hopping, Exec. Vice Pres. & CFO, Jackson Nat'l Life Ins. Co. to Richard Newman, NAIC (Sept. 30, 2009) (on file with author) [http://naic.org/documents/committees\\_e\\_091014\\_materials.pdf](http://naic.org/documents/committees_e_091014_materials.pdf).

<sup>359</sup> See NAIC, *Re: RFP 1344 – Assessment of Residential Mortgage Backed Securities (RMBS)* 13 (Oct. 23, 2009) [http://naic.org/documents/svo\\_rmbs\\_rfp\\_102309.pdf](http://naic.org/documents/svo_rmbs_rfp_102309.pdf).

<sup>360</sup> *Estimated RBC Impact from the RMBS Initiative 1* (Apr. 8, 2010), *available at* [http://www.naic.org/rmbs/100408\\_rbs\\_impact\\_estimate.pdf](http://www.naic.org/rmbs/100408_rbs_impact_estimate.pdf). The values are for the year-end 2009 risk-based capital requirement. After taking correlation into account, the reduction was smaller in absolute terms but about the same in percentage terms: the change reduced the amount of life insurers' post-correlation capital charge attributable to RMBS credit risk from \$8.4 billion to \$3.0 billion, or 65%. (total life insurer capital charge from NAIC par value is about \$178 billion and book adjusted carrying value about \$151 billion).

<sup>361</sup> Scott Robinson, *Most U.S. Life Insurers RMBS Capital Relief from Change in Computation, Not Switch to PIMCO*, Final Report of the RAWG to the Financial Conditions (E) Committee: Comment Letters 1, 1 (Jan. 11, 2010), *available at* [http://www.naic.org/committees\\_e\\_rating\\_agency.htm](http://www.naic.org/committees_e_rating_agency.htm) (click on "rating Agency WG Final Report:" then proceed to Section 8 of pdf).

<sup>362</sup> Letter from Charles Brown, General Counsel, Fitch Ratings to Richard

## B. THE RULE BAILOUT IN CONTEXT

It seems that the problem ACLI identified with the regulators' use of ratings to assess the risk of RMBS, assuming it was a problem at all, existed before the crisis and was not a product of the crisis. Whatever the merits of the underlying argument about recovery values on RMBS versus corporate bonds, this episode illustrates the willingness of regulators to adjust capital requirements to fit the interests of regulated parties during a systemic crisis. ACLI expressly justified its request on the basis of the old rules' "unwarranted" and "severe" impact on required capital.<sup>363</sup> It parallels other examples of departure from established rules and customs during the crisis, such as the dubiously legal abandonment of long-standing Federal Reserve practices to make unprecedented loans,<sup>364</sup> and the bank-friendly amendment of fair value (or "mark-to-market") accounting rules in March 2009, by the Financial Accounting Standards Board (FASB).<sup>365</sup>

The mark-to-market changes were widely viewed as a form of regulatory "forbearance."<sup>366</sup> Although mark-to-market rules have their critics, including some who are known more for trust in markets than doubts about them,<sup>367</sup> the sudden discovery in the midst of a crisis that

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Newman, NAIC, Bob Carcano, NAIC, & Dan Daveline, NAIC, Final Report of the RAWG to the Financial Conditions (E) Committee: Comment Letters 1, 4 (Jan 5, 2010) (on file with author) available at [http://www.naic.org/committees\\_e\\_rating\\_agency.htm](http://www.naic.org/committees_e_rating_agency.htm) (click on "Rating Agency WG Final Report:" then proceed to Section 6 Fitch Ratings of pdf).

<sup>363</sup> See ACLI Aug. 10, 2009 Letter, *supra* note 318, at 2.

<sup>364</sup> See Steven M. Davidoff & David Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463, 477 (2009).

<sup>365</sup> See Kara Scannell, *FASB Eases Mark-to-Market Rules*, WALL ST. J., Apr. 3, 2009 (describing banking industry's argument for changing rule and FASB's decision to do so).

<sup>366</sup> Jonathan Weil, *Suing Wall Street Banks Never Looked So Shady*, BLOOMBERG.COM, Feb. 24, 2010. <http://www.bloomberg.com/news/2010-02-24/suing-wall-street-banks-never-looked-so-shady-jonathan-weil.html>. See also James Chanos, *We Need Honest Accounting*, WALL. ST. J., March 24, 2009 (characterizing relaxation of capital requirements as an alternative, and superior, method of providing regulatory relief as compared to changing mark-to-market rules).

<sup>367</sup> See Richard A. Epstein & M. Todd Henderson, *Marking to Market: The Dangerous Allure of Mark to Market*, 22-23 (U. of Chi. Law & Econ., Olin Working Paper No. 458, 2009), available at



these rules are “procyclical” – a fact that apparently had gone unnoticed by those in a position to make or influence policy when marking to market was, presumably, procyclically inflating a bubble – suggests that the mark-to-market relief was indeed a form of “rule bailout.” Certainly, the banking industry – in both its GSE<sup>368</sup> and private<sup>369</sup> segments – supported the changes, although some commentators questioned whether the game was worth the candle for the banks, given the relatively small percentage of their assets that was even subject to mark-to-market accounting.<sup>370</sup>

[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1385382](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1385382).

<sup>368</sup> See Letter from Michael Gutttau, Chmn., & John L. von Seggern, Pres. & CEO, Council of Fed. Home Loan Banks to Russell G. Golden, Technical Dir., Fin. Acct. Standards. Bd., 1 (March 27, 2009) (on file with author) (proposed changes to FAS 157 “an improvement over existing guidance”) *available at* <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&bkey=id&blobwhere=1175818328874&blobheader=application/pdf> [hereinafter Council Letter 132]; Letter from Michael Gutttau, Chmn., Council of Fed. Home Loan Banks & John L. von Seggern, President & CEO, Council of Fed. Home Loan Banks to Russell G. Golden, Technical Dir., Fin. Acct. Standards. Bd., 1 (March 27, 2009) (on file with author) (proposed changes to FAS 115, 125, and EITF 99-200 “an improvement” over existing guidance, but do not go far enough) *available at* <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&bkey=id&blobwhere=1175818329600&blobheader=application/pdf>, (hereinafter Council Letter 98).

<sup>369</sup> See Letter from Donna Fisher, Sr. Vice President, Am. Bankers Ass’n to Russell Golden, Technical Dir., Fin. Acct. Standards. Bd., (March 30, 2009) (on file with author) (“We strongly support” proposed changes to FAS 157), *available at* <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&bkey=id&blobwhere=1175818331124&blobheader=application/pdf> [hereinafter ABA Letter 31A]; Letter from Donna Fisher, Sr. Vice President., Am. Bankers Ass’n to Russell Golden, Technical Dir., Fin. Acct. Standards. Bd. (March 30, 2009) (“Overall, ABA supports the proposed” changes to FAS 115, 124, and EITF 99-20-b), *available at* <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&bkey=id&blobwhere=1175818430414&blobheader=application/pdf> (hereinafter ABA Letter 31).

<sup>370</sup> David Reilly, Commentary, *Elvis Lives, and Mark-to-Market Rules Fuel Crisis*, BLOOMBERG.COM, March 11, 2009, <http://www.bloomberg.com/apps/news?pid=newsarchive&sis=aD11FOjLK1y4> (reporting analysis of company data finding that only 29% of assets of the 12 largest banks were held in mark-to-market categories at year-end 2008). Of

### C. IMPLICATIONS FOR CAPITAL REGULATION

The insurance industry's experience with rating failure on RMBS and the resulting rule bailout has three major implications for capital regulation. First, the tendency toward rule bailouts causes capital regulations to be less pro-cyclical than they otherwise would be. Second, if regulators have a tendency toward rule bailouts in financial crises, that suggests that policymakers should not put too much stock in prompt corrective action requirements that order regulators to take ailing companies into receivership. Both these points seem to weigh in favor of higher capital requirements than would otherwise be justified. Finally, the failure of correlation-sensitive ratings on RMBS suggests caution in adopting suggestions that entail greater regulatory reliance on correlation measures.

#### 1. Built-in Countercyclicality and Regulatory Forbearance

There has been acute interest in macro-prudential regulation since the crisis began. Macro-prudential regulation “concerns itself with factors that affect the stability of the financial system as a whole.”<sup>371</sup> One type of macro-prudential regulation is adopting countercyclical capital adequacy requirements – requiring that firms hold more capital in a boom and less in a crisis.<sup>372</sup> Another proposal for macro-prudential regulation would be permitting institutions with access to long-term funding – perhaps including insurers – to value their assets using long-term third party valuations rather than market prices.<sup>373</sup> As described in Part IV<sup>374</sup>, the

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course, a highly leveraged institution could be rendered insolvent by losses on a relatively small percentage of its holdings.

<sup>371</sup> MARKUS BRUNNERMEIER ET AL., *supra* note 167, at viii.

<sup>372</sup> *Id.* at 29 (capital regulation measures “have to be counter-cyclical, i.e., tough during a credit boom and more relaxed during a crisis”).

<sup>373</sup> See, e.g., Avinash D. Persaud, *The Rise and Apparent Fall of Macro-Prudential Regulation*, VOXEU.ORG, June 24, 2009, <http://www.voxeu.org/index.php?q=node/3694>; Avinash D. Persaud, *Regulation, Valuation, and Systemic Liquidity*, 12 BANQUE DE FRANCE FIN. STABILITY REV. 75, 79 (2008). As explained, insurance regulation in the United States already follows this prescription for capital regulation, as non-impaired insurer assets are not marked to market for regulatory purposes. [check]

<sup>374</sup> Goodhart, *supra* note 264, at 14-15 (previously viewed as having little, or

consensus not long ago was that insurance companies did not pose a systemic risk. Although that consensus has come under pressure because of the financial crisis, proponents of macro-prudential regulation tend to believe that because of this, insurance companies need only micro-prudential regulation.<sup>375</sup>

As described above, recent events have challenged the assumption that insurers pose no systemic risk, so macro-prudential regulation, at least of certain insurers, may be appropriate. If so, the possibility of rule bailouts affects the extent to which a given capital requirement is procyclical. Capital requirements are said to be procyclical in part because they can prompt cycles of fire sales when prices are low. Asset prices go down, forcing entities to sell assets to satisfy capital requirements, which drives prices down more. The capital requirement deepens the downward leg of the cycle. Rule bailouts mitigate this effect because regulators find ways not to require the forced sales just described.

At the same time, rule bailouts seem to embody a kind of unprincipled forbearance. The tendency to forbear seems to reflect the worst incentives of regulators: to hope for the best, or at least that the worst will not happen on the regulator's watch. Such a tendency to push problems off into the future would be consistent with insurance regulators' reported tendency to underprice ex ante premiums for guarantee funds.<sup>376</sup>

Unbridled regulatory forbearance can in some circumstances be a very bad idea— that is typically understood to be one of the central lessons of the S&L crisis. Regulators may decline to take aggressive action to wind up an insolvent firm, hoping along with the firm's management that the firm will turn itself around.<sup>377</sup> In the meantime, the firm takes greater and greater risks in an effort to extricate itself from insolvency.<sup>378</sup> This *pas de deux* can increase the ultimate cost of resolution dramatically.<sup>379</sup> The

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no, leverage" suggesting to the need for "micro-prudential regulation").

<sup>375</sup> See BRUNNERMEIER ET AL., *supra* note 16, at 24; Goodhart, *supra* note 264, at 15.

<sup>376</sup> See David Cutler & Richard Zeckhauser, *Extending the Premiums to Meet the Practice*, in PAPERS ON FINANCIAL SERVICES 1, 34 (Robert E. Litan & Richard Herring eds., 2004). ]

<sup>377</sup> See Daniel Schwarcz, *Regulating Insurance Sales or Selling Insurance Regulation? Against Regulatory Competition in Insurance*, 94 MINN. L. REV. 1707, 1763 – 1764 n.256 (2010).

<sup>378</sup> See FREDERIC S. MISHKIN, THE ECONOMICS OF MONEY, BANKING, AND FINANCIAL MARKETS 294-95 (8th ed. 2007).

<sup>379</sup> See Martin F. Grace et al., *Insurance Company Failures: Why Do They Cost So Much?*, Ga. State Univ. Working Paper 03-1 (Oct. 30, 2003), at 29,

insurance industry and its regulators<sup>380</sup> were accused of behaving similarly to S&Ls and their regulators during the era of the S&L crisis, which also saw several high-profile insurance insolvencies.<sup>381</sup> Thrift and insurance regulators both became subject to “prompt corrective action” (PCA) requirements during this period. As described in Part II.A.2 above, PCA requirements direct the regulator to take action when capital levels fall below specified thresholds. They are designed to prevent forbearance. Rule bailouts illustrate a problem with a system that relies on PCA requirements to force regulators to take unpleasant actions during a crisis. The regulators can just change the rules to circumvent the requirements.<sup>382</sup>

Before being too hard on regulators for their rule bailouts, we should remember that no massive wave of insolvencies has appeared in the insurance sector in the current crisis— at least to date.<sup>383</sup> And NAIC’s CEO reminds us that some scholars believe that NAIC’s changes to asset valuation rules in the 1930s helped insurance companies survive the Great

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available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=463103](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=463103) (reporting the results of an empirical study finding that there are three main components of resolution costs: “the pre-insolvency condition of the firm; the degree of regulatory forbearance; and the transparency of post-insolvency administration”).

<sup>380</sup> See STAFF OF H. SUBCOMM. ON OVERSIGHT AND INVESTIGATIONS OF THE COMM. ON ENERGY AND COMMERCE, 101ST CONG., FAILED PROMISES: INSURANCE COMPANY INSOLVENCIES 6 (Comm. Print 1990) [*hereinafter* FAILED PROMISES] (“The same patterns of industry and regulatory conduct [as in the S&L industry] have emerged from the Subcommittee’s recent investigations of insurance company insolvencies.”); see also STAFF OF H. SUBCOMM. ON OVERSIGHT AND INVESTIGATIONS OF THE COMM. ON ENERGY AND COMMERCE, 103D CONG., WISHFUL THINKING: A WORLD VIEW OF INSURANCE SOLVENCY REGULATION 6 (Comm. Print 1994) (“The single, overriding weakness plaguing the supervision of domestic and foreign insurance companies is the widespread practice of wishful thinking by regulatory officials.”).

<sup>381</sup> See FAILED PROMISES, *supra* note 349, at 2 (“The Subcommittee examined in great detail the failures of Mission Insurance Co., Integrity Insurance Co., Transit Casualty Co., and Anglo-American Insurance Co. Collectively, these four failures are projected to cost the American public more than \$5 billion...”).

<sup>382</sup> Cf. Brunnermeier et al., *supra* note 16, at 33-34 (arguing that macroprudential regulation should be implemented by rules rather than regulatory discretion: Otherwise, few regulator/supervisors will actually dare to face the odium of tightening in boom conditions.).

<sup>383</sup> See Martin Grace, *A Reexamination of Federal Regulation in the Insurance Industry*, at 1-2, Networks Financial Institute Policy Brief No. 2009-PB-02 (Feb. 2009). available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=135053](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=135053)

Depression with only modest insolvencies and policyholder losses.<sup>384</sup> Although we would expect any such wave would appear only after a lag, the general recovery in credit markets since 2008 and early 2009 suggests that the very large credit spreads in those periods did not forecast corresponding high levels of credit loss, perhaps because they reflected high risk aversion and an absence of liquidity. So perhaps this particular rule bailout will turn out to have been justified, at least from a short-term perspective.

Whether any specific rule bailout was justified or not, the possibility of rule bailouts seems to weigh in favor of higher capital requirements. The negative consequences of a high requirement are smaller, because there is less chance of forced fire sales during a crisis, and the benefits of a high requirement are greater, because rule bailouts and forbearance increase the costs of distress, placing a higher premium on staying out of distress.

## 2. Ratings in Crisis and the Asset-by-Asset Debate

The RMBS experience sheds light on another debate in capital regulation, the asset-by-asset debate. The RBC formula has been attacked for years on the ground that it does not give enough credit to ideas from financial economics about the value of diversification.<sup>385</sup> The RBC formula, so we have been told, fails to take a portfolio approach to assessing risk. The Model Investment Law, at least in its Defined Limits Version, has come in for equally severe criticism.<sup>386</sup> These criticisms do

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<sup>384</sup> Therese M. Vaughan, *The Implications of Solvency II for U.S. Insurance Regulation* 18 & n.25, Networks Financial Institute Policy Brief 2009-PB-03 (Feb. 2009), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1350539](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1350539) (noting that NAIC altered asset valuation rules not just in the 1930s, but also in “periods of market turmoil in 1907, 1914, and 1917-21”).

<sup>385</sup> See, e.g., Schwarcz, *supra* note 346, at 1765 (RBC formula “does a poor job accounting for insurers’ diversification and risk mitigation measures, employing a simple covariance formula that does not credit standard hedging techniques, much less sophisticated portfolio design.”).

<sup>386</sup> See, e.g., Lawrence J. White, *The NAIC Investment Law: A Missed Opportunity*, in *THE STRATEGIC DYNAMICS OF THE INSURANCE INDUSTRY: ASSET/LIABILITY MANAGEMENT ISSUES* (Edward I. Altman & Irwin T. Vanderhoof, eds. 1996) 41, 41 (arguing that NAIC’s draft Model Investment Law misses a “once-in-a-generation” opportunity by “adopt[ing] a ‘pigeon-hole’ approach that addresses categories of risk assets (and activities) on a standalone basis, ignoring portfolio effects and the potential for offsetting interactions among

deserve to be taken seriously, as I have argued elsewhere.<sup>387</sup>

The value of diversification depends on how the assets in the portfolio move together. The idea of co-movement is usually expressed using the term “correlation,” a numerical measure of co-movement that ranges from -1 to 1. The lower the correlation between each pair of assets, the greater the diversification benefit of each pair of assets. The criticism of the RBC system and Model Investment Law is that it does not give enough credit for diversification. In fact, as explained in Part II.A.1 above, the RBC system assumes that credit risks have a correlation of 1 – that is, that there is no diversification benefit.

Under normal circumstances most assets are not perfectly correlated with one another so the perfect-correlation assumption is too conservative, just as critics claim. But it is a common saying in the financial community that “in a crisis, all correlations go to one.”<sup>388</sup> And in fact defaults on the mortgages underlying RMBS turned out to be more correlated during the crisis than rating agencies or many investors anticipated. Indeed, the high ratings and subsequent downgrades on the RMBS in question were based in large part on diversification benefits that failed to materialize in the crisis.

If a capital regulation system is to be designed so that the regulated companies meet specified probabilities of survival during a financial crisis, the assumption that credit risks are perfectly correlated looks more like a prudent, conservative design feature than a technologically retrograde failure to keep up with contemporary thought. The failure of ratings on novel products counsels caution about importing higher levels of sophistication into the capital regulation system, at least without sufficient testing of the underlying assumptions.

#### VIII. THE CASE FOR A RATINGS SEASONING REQUIREMENT IN REGULATION

The performance of insurance solvency regulation during the financial crisis mapped to the performance of the ratings on which regulators’ solvency determinations are based. Regulated life and property & casualty insurers were not heavily exposed to products on which ratings

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the categories.”).

<sup>387</sup> See Hunt, *supra* note 255, at 776-77..

<sup>388</sup> RICHARD M. BOOKSTABER, A DEMON OF OUR OWN DESIGN: MARKETS, HEDGE FUNDS, AND THE PERILS OF FINANCIAL INNOVATION 269 (John Wiley & Sons, Inc. eds., 2007)..

failed, and they by and large escaped insolvency. AIG and financial guaranty insurers were heavily exposed to products on which ratings failed, and they did suffer insolvency.

The ratings that failed were ratings on novel products. Substantial evidence indicates that agencies simply did not know what they were doing in rating these products. Although rating agencies have sometimes been successful in rating novel products right out of the box, it seems hard to dispute that ratings on novel products are less reliable than ratings on more seasoned products.

Rating failure on novel products may or may not indict rating agencies. Perhaps their performance was as good as anyone had a right to expect. The experience does highlight a potential problem with the design of the regulatory system, though. Rating-dependent regulation of the insurance industry treats all ratings, on novel and traditional products, as the same. But they are not the same, because ratings on novel products can be expected to be less reliable. As a simplifying device, imagine two ratings, one on a traditional industrial corporate bond and one on a novel structured product. Assume for the sake of argument that each rating corresponds to a 75% chance of default and that 75% is in fact the best estimate of the chance of default for each obligation.<sup>389</sup> But the corporate-bond rating may be more reliable: Think of a 75% +/- 5% chance of default for that bond, as opposed to a 75% +/- 25% chance of default for the novel bond. A regulatory system that wants insurers to hold only bonds with a chance of default reasonably close to 75% might well admit the first rating and not the second.

If all bond ratings should not be treated equally, how should regulators decide which ratings to credit? A simple seasoning requirement could be used to distinguish between reliable and less-reliable ratings. For example, if ratings on novel products did not “count” for regulatory purposes until a substantial volume of the product had been on the market for some period designed to correspond to the length of the credit cycle, perhaps 5-7 years, this would allow regulators and credit rating agencies to observe the product’s performance under varying economic and market conditions, so that final ratings would be more reliable.<sup>390</sup>

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<sup>389</sup> As discussed, rating agencies state that ratings do *not* correspond to specified default probabilities, although some researchers have concluded that S&P’s CDO ratings were designed to achieve just such probabilities.

<sup>390</sup> A seasoning requirement for giving regulatory effect to ratings is in some respects a partial substitute for a more general system for deterring issuance of low-quality ratings on novel products. For example, if a rule requiring

Such a seasoning requirement would be a more narrowly tailored change to rating-dependent regulation than other proposals that are under consideration or that have been adopted. For example, the first-draft RAWG proposal to eliminate rating-dependent regulation on structured products seems to give short shrift to rating agencies' ability to learn from mistakes. Dodd-Frank's requirement that rating-dependent regulation be eliminated at the federal level is even more sweeping.

The strongest argument for sweeping elimination of rating-dependent regulation is that RDR damages rating quality. But the heavily rating-dependent regulatory system apparently has not degraded rating quality to unacceptable levels for traditional obligations. Although scholars have argued that ratings do not add value in the sense of improving on what anyone with access to the financial press could accomplish,<sup>391</sup> that level of quality seems "good enough for government work,"<sup>392</sup> as other scholars have argued. Rating-agency critiques of the pernicious effect of rating-dependent regulation on agency incentives likewise focus on RDR's effects in the context of novel products.

A seasoning requirement for rating-dependent regulation could conceivably impede the development of novel financial products, as rating-regulated investors would effectively be barred from purchasing such products. Of course, the overall social utility of financial-product innovation is the subject of an unresolved debate, and in that sense it is unclear that this objection has any force at all. In any event, hedge funds and accredited individual investors are not subject to rating-dependent regulations and would be able to purchase novel products. And under Dodd-Frank, ratings are to be excised from federal regulations anyway, creating another potential market for unrated products.

From a political-economy point of view, a seasoning requirement is more feasible than more aggressive RDR-reduction measures. The seasoning requirement could be implemented by NAIC via a change to Rule FE, so that a state-by-state effort is unnecessary. Industry is spared the expense of paying for efforts that duplicate reliable rating-agency efforts. The seasoning requirement addresses Moody's and S&P's major

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disorgement of profits on low-quality profits were adopted, *see* Hunt, *Credit Rating Agencies*, *supra* note 148, at 53, then we might expect agencies not to issue low-quality ratings on novel products, so that no seasoning requirement would be needed.

<sup>391</sup> Partnoy, *Two Thumbs Down*, *supra* note 246, at 509.

<sup>392</sup> Claire A. Hill, *Why Did Anyone Listen to the Rating Agencies After Enron?*, 4 J. BUS. & TECH. L. 283, 283 (2009).



criticisms of RDR, and the other rating agencies have adopted essentially an agnostic line. By adopting a bright-line seasoning rule, regulators would avoid taking responsibility for each and every decision to permit insurers to make investments. At the same time, seasoning reduces one potentially harmful political-economy effect: rule bailouts. If rating performance is more reliable, it is less likely that ratings will perform in unexpectedly negative ways that result in industry's demanding a rule bailout.

Given NAIC's evident lack of interest in complete eradication of RDR at this time, an effort to do so seems likely to require a costly state-by-state battle. Congress could take action, but states have successfully resisted federal efforts to encroach on their authority for nearly 70 years. Arguments based on systemic risk might provide some traction, but they don't really apply to core insurance activities, with the possible exception of financial guaranty insurance, which effectively has a single regulator already.

## IX. CONCLUSION

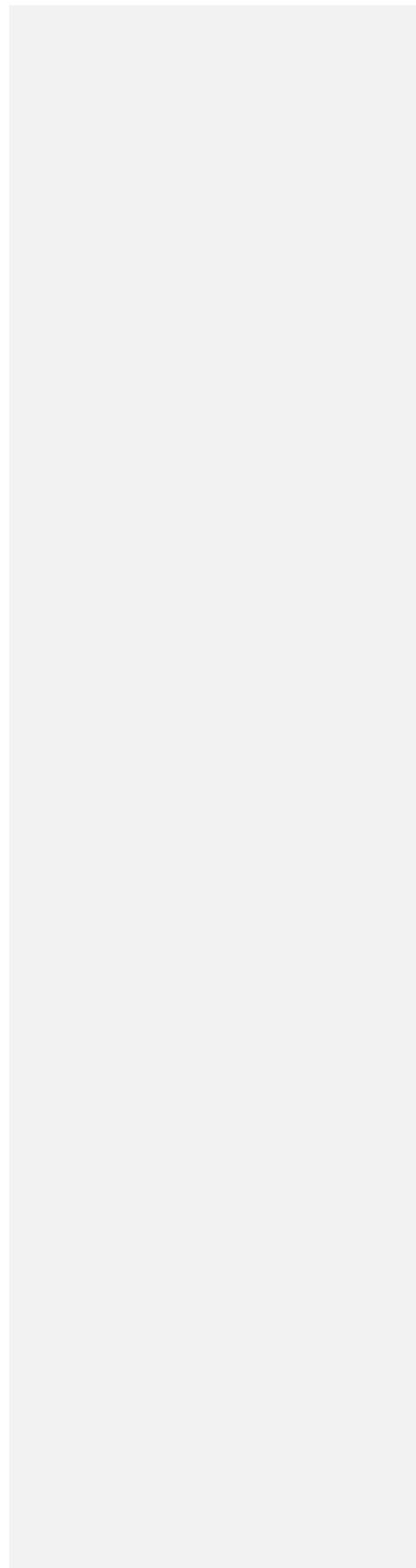
Rating-agency reformers have good arguments for removing private credit ratings from the regulatory system. At the same time, financial regulators have both good reasons and strong incentives to continue relying on private credit ratings or something very much like them. Congress' recent expression of desire to eliminate credit ratings from financial regulation, taken together with state insurance regulators' reaffirmation of the role of ratings in regulation, sets the stage for a confrontation on this score.

One approach to addressing the problem of rating-dependent regulation would be for regulators to stop relying on "unseasoned" ratings – that is, ratings on novel financial products without a significant history of market experience. Such ratings should be less reliable than ratings on traditional products. Recent events with CDOs and subprime RMBS suggest that that was the case, and that regulatory reliance on novel product ratings created systemic risk and pressure for rule bailouts that reliance on traditional ratings did not. Selectively reducing rating reliance by focusing on unseasoned ratings preserves the benefits that regulators and the regulated industry derive from the present system while addressing the most serious problems with rating-dependent regulation.

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RATING DEPENDENT REGULATION

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***METROPOLITAN LIFE INSURANCE COMPANY V. GLENN:  
WILL THE SUPREME COURT DECISION REDUCE  
CONFUSION AFTER FIRESTONE?***

*Ryan M. LoRusso\**

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*A recent report to the United States Congress indicated that about 131 million Americans are currently enrolled in employee benefit plans which fall under the jurisdiction of the Employee Retirement Income and Security Act of 1974 (ERISA). Some plans are structured so that the plan administrator will be paying benefits out of the firm's profits. The possibility exists that the administrator may be swayed to decide in favor of the company in an effort to protect the financial health of the company which employs him. Recently, in Metropolitan Life Insurance Company v. Glenn, the Supreme Court addressed the questions of whether a plan administrator that pays benefits out of company profits is acting under a conflict of interest, and if so, how the conflict of interest should be taken into account upon review by a court. Prior to the Supreme Court's decision in Glenn, the circuit courts had been employing a variety of approaches in taking this apparent conflict into account.*

*This note begins by providing an overview of the areas of trust law impacting the Court's decision and then reviews the case-law prior to the Supreme Court decision. The note then discusses the decision in Glenn and the case law that has developed following the Court's decision. This comment argues that the Supreme Court made the correct decision by holding that this scenario did constitute a conflict of interest, and by allowing the circuit courts to take the conflict into account by weighing it among a variety of other factors.*

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**I. INTRODUCTION**

A recent report to the United States Congress indicated that about 131 million Americans<sup>1</sup> are currently enrolled in employee

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\* J.D. candidate, University of Connecticut School of Law, 2011.  
Thanks to my Mom, Dad, sister Angela, and Holly for your support

benefit plans which fall under the jurisdiction of the Employee Retirement Income and Security Act of 1974 (ERISA).<sup>2</sup> In some plans, the plan administrator will be paying benefits out of the same pool of money as profits are derived. Recently, in *Metropolitan Life Insurance Company v. Glenn*, an employee enrolled in an employee benefit plan falling under the jurisdiction of ERISA was denied benefits by a plan administrator. The administrator would have paid the benefits out of the same funds as which profits are derived. The employee appealed the denial and the question was presented to the Supreme Court of whether an insurer that pays benefits out of the same funds as its profits are derived is acting under a conflict of interest under ERISA.<sup>3</sup> Prior to the Supreme Court's decision in *Glenn*, the circuit courts had been employing a variety of approaches in taking this apparent conflict into account. This paper reviews the law prior the Supreme Court decision and the case law that has developed following the Supreme Court's decision in *Glenn*. This paper argues that the Supreme Court made the correct decision by stating that this scenario did constitute a conflict of interest, and by allowing the circuit courts to take the conflict into account by weighing it among a variety of other factors.

## II. HISTORY

### A. TRUST LAW AS APPLIED EMPLOYEE BENEFIT PLANS

The U.S. Supreme Court has stated that principles of trust law must guide the courts in determining the appropriate standard of

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throughout law school and in writing this comment. Also, thanks to Professor McCoy for your help in revising this comment.

<sup>1</sup> CONG. RES. SERVICE, ERISA Regulation of Health Plans: Fact Sheet, *available at* <http://www.allhealth.org/briefingmaterials/erisaregulationofhealthplans-114.pdf>.

<sup>2</sup> *See generally* Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1001-1461 (1994).

<sup>3</sup> *Metro. Life Ins. Co. v. Glenn*, 554 U.S. 105 (2008).

review of a denial of benefit claims under ERISA.<sup>4</sup> Therefore, a short discussion of the relevant trust law principles may be helpful. First, a trust as defined by the Restatement (Third) of Trusts is a fiduciary relationship with respect to property, and subjects the trustee to the duty to act in the best interest of the beneficiaries.<sup>5</sup> As applied in the context of this case, the Supreme Court stated that those administering employee-benefit plans must be guided by principles of trust law.<sup>6</sup> To begin, trust law generally prohibits a fiduciary from acting under a conflict of interest.<sup>7</sup> However, an exception exists if the trustee was appointed by a settler who is aware of the trustee's conflict of interest.<sup>8</sup> The Restatement takes the position that a conflict of interest alone is not enough to remove a trustee, but when "conflict of interest situations exist, the conduct of the trustee in the administration of the trust will be subject to especially carefully scrutiny."<sup>9</sup> Furthermore, when a conflict of interest situation is approved by the settler, the "trustee-beneficiary's conduct is to be closely scrutinized for abuse, including abuse by less than appropriate regard for the duty of partiality."<sup>10</sup> The Restatement also provides guidance to determine when an abuse of discretion may exist and lists several factors including: "the existence or nonexistence of an interest in the trustee conflicting with that of the beneficiaries."<sup>11</sup> A leading treatise concurs stating that the extent of discretion conferred upon the trustee and any conflict of interest with

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<sup>4</sup> *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 110 (1989).

<sup>5</sup> RESTATEMENT (THIRD) OF TRUSTS § 2 (2003).

<sup>6</sup> *Firestone*, 489 U.S. at 110-11.

<sup>7</sup> George Gleason Bogert, *Trusts and Trustees* § 534 (1993).

<sup>8</sup> AUSTIN W. SCOTT & WILLIAM F. FRATCHER, *THE LAW OF TRUSTS* §107.1 (4th ed. 1987 & Supp. 2001).

<sup>9</sup> RESTATEMENT (THIRD) OF TRUSTS § 37 cmt. F, illus. (1) (2003).

<sup>10</sup> *Id.* at § 79 cmt. B, illus. (1).

<sup>11</sup> RESTATEMENT (SECOND) OF TRUSTS § 187 (1959).

the beneficiaries must be taken into account in determining an abuse of discretion.<sup>12</sup>

In *Metropolitan Life Insurance Company v. Glenn* (*Glenn*),<sup>13</sup> the trustee was given discretionary powers in administering the trust. Generally, this means that a court will not interfere with a trustee's exercise of a discretionary power when that exercise is reasonable and not based on an improper interpretation.<sup>14</sup> But, what constitutes an abuse of discretion is not a rigid, constant standard. The point at which an abuse of discretion is reached will vary, depending upon the basic fiduciary duties and the terms of the trust, including the amount of discretion given to the trustee.<sup>15</sup> Of course, acting on the basis of an improper motive is a factor that can be considered by a court when determining if a trustee abused his discretion.<sup>16</sup> Also, it is important to note that "abuse of discretion" is a legal conclusion that the trustee has exceeded the amount of discretion given to him in the trust, and not the standard under which a court reviews the trustee's actions.

#### B. THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

The Employee Retirement Income Security Act of 1974 (ERISA) plays a central role in *MetLife v. Glenn*; therefore, a limited discussion of ERISA will be helpful. ERISA was enacted by Congress to protect the interests of employee-benefit plan participants by requiring the disclosure of relevant financial information to beneficiaries, by establishing standards of conduct, responsibility, and obligations for fiduciaries of employee-benefit plans, and by providing for appropriate remedies, sanctions, and

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<sup>12</sup> AUSTIN W. SCOTT & WILLIAM F. FRATCHER, *THE LAW OF TRUSTS* §187 (4<sup>th</sup> ed. 1987).

<sup>13</sup> *Metro. Life Ins. Co. v. Glenn*, 128 S. Ct. 2343 (2008).

<sup>14</sup> RESTATEMENT (THIRD) OF TRUSTS § 50 cmt. a (2003).

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

ready access to the federal courts.<sup>17</sup> Also, ERISA preempts virtually all state laws in conflict with it, and no other federal law systematically regulates employee benefit plans.<sup>18</sup>

Before ERISA was enacted, employee benefit and pension plans operated with no substantial federal regulation.<sup>19</sup> There were various bodies of state law which would act to protect employees prior to ERISA, but Congress determined this type of piecemeal approach to be insufficient to protect employees' interests and expectations.<sup>20</sup> Specifically, Congress found that the minimum standards governing then existing plans to be insufficient; that plan funds were inadequate to pay promised benefits; and that plans terminated before accumulating enough funds to pay employees their expected benefits.<sup>21</sup> Accordingly, the stated purposes of the law include establishing a uniform source of law to govern the administration of employee-benefit plans, and promoting and protecting employee's interests and expectations in the plans. In addition to those purposes cited by the statute itself, there are numerous judicially-declared purposes to the statute.<sup>22</sup> Some of the most relevant include encouraging employers' to adopt employee benefit plans,<sup>23</sup> while also giving employers a degree of flexibility in administering the plans.<sup>24</sup> To further encourage plan creation, Congress intended to minimize the administrative burdens imposed

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<sup>17</sup> 60A AM. JUR. 2D *Pensions* § 1 (2003).

<sup>18</sup> Jay Conison, *Foundations of the Common Law of Plans*, 41 DEPAUL L. REV. 575, 576 (1992). See also Kathryn J. Kennedy, *Judicial Standard of Review in ERISA Benefit Claim Cases*, 50 AM. U. L. REV. 1083, 1098-1109 (2001) (for an in depth discussion of case-law pre-*Firestone*).

<sup>19</sup> Kevin Walker Beatty, Commentary, *A Decade of Confusion: The Standard of Review for ERISA Benefit Denial Claims as Established by Firestone*, 51 ALA. L. REV. 733, 733 (2000).

<sup>20</sup> *Id.*

<sup>21</sup> 60A AM. JUR. 2d *Pensions* § 1 (2003).

<sup>22</sup> *Id.* § 2.

<sup>23</sup> *Siskind v. Sperry Ret. Program*, 47 F.3d 498, 505 (2d Cir. 1995).

<sup>24</sup> *Id.* at 501.

on employers by creating a standardized set of procedures.<sup>25</sup> The Court in *Glenn* noted that Congress believed that removing the unpredictability that resulted from the application of various state laws would encourage the creation of employee benefit plans, but the unpredictability that results from an opaque standard of review could also impede Congress's goal of encouraging plan creation. Also, the Supreme Court has stated that the principal goal of ERISA is to protect the interests of plan participants and beneficiaries.<sup>26</sup> Courts have also stated that ERISA was enacted to protect employees from employers who could pursue their own interests in the management of the retirement plan.<sup>27</sup>

To ensure the realization of its stated goals, ERISA provides that a fiduciary "shall discharge his duties with respect with respect to a plan solely in the interest of participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries"<sup>28</sup> while using the care, skill, diligence, and prudence of prudent man in a similar situation.<sup>29</sup> To ensure the statutory goals are enforced, ERISA allows a plan participant or beneficiary to bring a civil suit in Federal Court to recover benefits due to him, enforce his rights under the plan, or clarify his right to future benefits under the plan.<sup>30</sup>

Despite its length, ERISA leaves many important issues to be interpreted by the courts.<sup>31</sup> So while Congress intended to provide a statutory grounding to employee-benefit law, the deference to the courts was partly a recognition by Congress that the law surrounding benefit plans had long been part of the common law.<sup>32</sup> Also, the gaps

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<sup>25</sup> *Egelhoff v. Egelhoff ex rel. Breiner*, 532 U.S. 141, 148 (2001).

<sup>26</sup> *Boggs v. Boggs*, 520 U.S. 833, 834 (1997).

<sup>27</sup> *NLRB v. Amax Coal Co.*, 453 U.S. 322, 333 (1981); *Reich v. Valley Nat'l Bank of Ariz.*, 837 F. Supp. 1259, 1262 (S.D.N.Y. 1993).

<sup>28</sup> *See generally* Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1001-1461 (2006).

<sup>29</sup> 29 U.S.C. § 1104(a)(1)B (2006).

<sup>30</sup> § 1132 (a)(1)B.

<sup>31</sup> Conison, *supra* note 18, at 576.

<sup>32</sup> *Id.*



in the statute reflect Congress's intent for the courts to experiment and refine the law surrounding benefit plans. There were no models for Congress to draw on when enacting ERISA, so in an effort not to upset settled law, Congress deferred to the courts on some of the more important parts of the law in this regard, including of course, the relevant standard of review.

C. FIRESTONE TIRE & RUBBER CO. V. BRUCH

The Court's decision in *Firestone* plays an important role in shaping the outcome of the *Glenn*. In *Firestone*, the Court addressed the appropriate standard of review of benefit determinations by fiduciaries or plan administrators under ERISA.<sup>33</sup> Firestone acted as the fiduciary of an employee-benefit plan which stated that workers were entitled to receive benefits if the workforce was reduced.<sup>34</sup> When Firestone sold three of its plants to another company, the workers brought suit under ERISA claiming that a reduction in workforce occurred entitling them to benefits.<sup>35</sup> Firestone denied the claim citing the fact that all of the workers were hired by the new company at the same positions and wages.

The Court in *Firestone* noted that ERISA sets out no standard of review under 1132(a)(1)(b) which allows a participant to challenge benefit determinations.<sup>36</sup> The Supreme Court noted that the federal courts had adopted the "arbitrary and capricious" standard to fill the gap left by the statute, mainly by analogizing the ERISA statute to the Labor Management Relations Act and borrowing its standard.<sup>37</sup> However, the Supreme Court found the adoption of this standard was inappropriate because of differences in the statutes—mainly the fact that courts used the standard to gain a jurisdictional

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<sup>33</sup> *Firestone Tire & Rubber Co. v Bruch*, 489 U.S. 101, 105 (1989).

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> *Id.* at 109.

<sup>37</sup> *Id.*

basis over the LMRA suits was not present because ERISA explicitly authorizes such suits.<sup>38</sup>

The Court held that when a court reviews a fiduciary's denial of benefits under ERISA, the court should be guided by principles of trust law.<sup>39</sup> The Court's conclusion was based upon the fact that the ERISA statute, while not setting forth a standard of review, "abounded" with language borrowed from the body of trust law.<sup>40</sup> The Court also found support for this conclusion in the legislative history.<sup>41</sup> The Court also noted that Congress wanted the courts to develop a federal common law in regards to the standard of review.<sup>42</sup>

Having settled that trust law principles should guide courts in the review of a fiduciary's denial of benefits, the Court then stated how these trust law principles should be applied. In *Firestone*, the plan administrator was not vested with any discretion when determining employees' benefits.<sup>43</sup> The Court looked to trust law and determined that when a fiduciary is not vested with any discretion, a de novo standard of review should apply.<sup>44</sup>

However, the Court continued at length on the appropriate standard of review when a fiduciary is given discretion, even though this was not essential to the decision. The Court cites the Restatement (Second) of Trusts for the principle that a deferential standard is appropriate if a trustee is given discretion in administering the trust.<sup>45</sup> The Court also stated in dicta: "Of course,

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<sup>38</sup> *Id.* at 109-10.

<sup>39</sup> *Firestone*, 489 U.S. at 110-11.

<sup>40</sup> *Id.* at 110.

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> *Id.* at 112-13.

<sup>44</sup> *Id.* at 112-15.

<sup>45</sup> Some courts would regard this deferential approach as a review for abuse of discretion and some courts would review under the arbitrary and capricious standard. The First Circuit stated that "abuse of discretion", "arbitrary and capricious", and "reasonableness" were functionally equivalent in the ERISA context. *Denmark v. Liberty Life Assurance Co. of Boston*, 566 F.3d 1, 7 (1st

if a benefit plan gives discretion to an administrator or fiduciary who is operating under a conflict of interest, that conflict must be weighed as ‘factor in determining whether there is an abuse of discretion.’”<sup>46</sup> The Court’s statement in *Firestone* is dictum because the facts did not present a fiduciary that was given any discretion in administering the trust. It is likely that the Court’s statement regarding fiduciaries with discretion was intended to provide guidance to the federal courts on the appropriate standard of review in those cases.

Given ERISA’s statutory goal of providing increased protection to employees, a de novo standard of review seems appropriate. However, under *Firestone* a plan can receive deferential review if it vests the fiduciary with discretion. Because most plans contain such language or can easily be made to contain such language, “the court . . . essentially nullified applying the standard that it deems most appropriate.”<sup>47</sup> Despite *Firestone*’s efforts to speak on the topic, the Circuit Courts would split on the appropriate way to determine if a conflict of interest constituted an abuse of discretion by a plan administrator.

#### D. DIFFERING CIRCUIT COURT APPROACHES AFTER FIRESTONE

Because *Firestone* did not clearly state how this conflict should be taken into account, the circuit courts subsequently developed several different approaches for taking a conflict of interest into account under ERISA.

##### 1. The “Presumptively Void” Approach

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Cir. 2009). The Seventh Circuit also stated that there is no difference between a review under the “arbitrary and capricious” standard and “abuse of discretion....” *Jenkins v. Price Waterhouse Long Term Disability Plan*, 564 F.3d 856, 861 n.8 (7<sup>th</sup> Cir. 2009).

<sup>46</sup> *Firestone*, 489 U.S. at 115.

<sup>47</sup> Beatty, *supra* note 19, at 739.

The presumptively void test has been adopted by the Eleventh Circuit and Ninth, with the Ninth later overruling it as inconsistent with Supreme Court precedent.<sup>48</sup> In *Brown v. Blue Cross & Blue Shield*, the Eleventh Circuit stated that when a conflict of interest exists, a conflicted fiduciary may favor, perhaps even unconsciously, his own interests over that of the beneficiaries.<sup>49</sup> The court reasoned that this would leave the beneficiaries unprotected unless the burden of proof shifted to the administrator to demonstrate that the conflict did not affect his decision.<sup>50</sup> Accordingly, the Eleventh Circuit held that when a “plan beneficiary demonstrates a substantial conflict of interest on the part of the fiduciary responsible for benefits terminations, the burden shifts to the fiduciary to prove that its interpretation of plan provisions committed to its discretion was not tainted by self-interest.”<sup>51</sup> If the fiduciary carries that burden, a court should review the fiduciary’s decision with deference and not under a de novo standard of review.<sup>52</sup>

The Ninth Circuit applied a “presumptively void” approach in *Atwood*<sup>53</sup> before overruling *Atwood* in *Abatie v. Aetna Health and Life Ins. Co.* in 2006.<sup>54</sup> In *Atwood*, the Ninth Circuit applied a traditional abuse of discretion standard to the decision of a conflicted trustee, unless the affected beneficiary produced some evidence that conflicted interest caused the fiduciary to breach a duty.<sup>55</sup> Under that method, a beneficiary was required to bring forth evidence showing that the conflict of interest affected the decision.<sup>56</sup> If no evidence

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<sup>48</sup> See *Atwood v. Newmont Gold Co.*, 45 F.3d 1317, 1323 (9th Cir. 1995); *Brown v. Blue Cross & Blue Shield of Alabama, Inc.*, 898 F.2d 1556 (11th Cir. 1990).

<sup>49</sup> *Brown*, 898 F.2d at 1565.

<sup>50</sup> *Id.*

<sup>51</sup> *Id.* at 1566.

<sup>52</sup> *Id.* at 1568.

<sup>53</sup> *Atwood*, 45 F.3d 1317.

<sup>54</sup> *Abatie v. Alta Health & Life Ins. Co.*, 458 F.3d 955, 966-69 (9th Cir. 2006)

<sup>55</sup> *Id.* at 1322-23.

<sup>56</sup> *Id.* at 1323.

other than the bare existence of the conflict existed, no heightened review was undertaken.<sup>57</sup> If evidence was brought forth, the court would be “very skeptical” in deferring to the decision of trustee with discretion.<sup>58</sup> The court deferred to trust law for the principle that an action taken by a fiduciary in violation of his duties is “presumptively void”, and so the trustee had the burden of proving the conflict did not affect his decision.<sup>59</sup> This approach is interesting because the presence of a conflict is not taken into account without evidence it affected the trustee’s decision and the standard of review remains the same. However, *Firestone* states that the conflict should be taken into account whether or not there is evidence to suggest it affected the trustee’s decision. In *Abatie*, the Ninth Circuit recognized that the approach of *Atwood* was not completely consistent with *Firestone* and overruled that approach<sup>60</sup>.

## 2. The Sliding Scale Test

The Third, Fourth, Seventh, and Tenth Circuits have adopted the “sliding scale” approach.<sup>61</sup> Under the sliding scale approach, a court will always apply an arbitrary and capricious standard, but a court will decrease the level of deference given to the conflicted

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<sup>57</sup> *Id.*

<sup>58</sup> *Id.*

<sup>59</sup> *Id.*

<sup>60</sup> *Abatie*, 458 F.3d at 966-69.

<sup>61</sup> See *Doe v. Group Hosp. & Med. Serv.*, 3 F.3d 80, 87 (4th Cir. 1993); *Wildbur v. ARCO Chem. Co.*, 974 F.2d 631, 638-42 (5th Cir. 1992); *Van Boxel v. Journal Co. Employees’ Pension Trust*, 836 F.2d 1048, 1052-53 (7th Cir. 1987); *Chambers v. Family Health Plan Corp.*, 100 F.3d 818, 824-27 (10th Cir. 1996).

administrator's decision in proportion to the seriousness of the conflict.<sup>62</sup>

In *Van Boxel*, the Seventh Circuit stated that it is necessary to maintain flexibility when reviewing a benefit denial by a plan administrator.<sup>63</sup> To this end, a "sliding scale" of review is most appropriate – the review is more searching and extensive the greater the suspicion of partiality.<sup>64</sup> Also, the court argued that this approach squares with the practice of judges to engage in a more extensive review when they believe there is a greater risk of the fiduciary being partial.<sup>65</sup> The Tenth Circuit has also that the "sliding scale" approach was more consistent with the flexible standard articulated in *Firestone*.<sup>66</sup> Implicitly, it seems that the court is arguing the courts have always employed a "sliding scale" approach—the courts would simply adjust the amount of deference they accorded under the "arbitrary and capricious" standard based on the presence of a conflict.

### 3. "Combination of Factors" Test

The "combination of factors" approach was adopted by the Sixth Circuit in *Calvert*.<sup>67</sup> In that case, the court stated that a "conflict of interest" was to be considered and weighed by a reviewing court among any other relevant factors that could lead to a finding of an abuse of discretion.<sup>68</sup> This approach was used to review Glenn's denial of benefits, and was upheld by the Supreme Court in *Glenn*.<sup>69</sup>

### 4. Eleventh Circuit

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<sup>62</sup> *Chambers*, 100 F.3d at 825.

<sup>63</sup> *Van Boxel*, 836 F.2d. at 1052.

<sup>64</sup> *Id.* at 1052-53.

<sup>65</sup> *Id.*

<sup>66</sup> *Chambers*, 100 F.3d. at 826-27.

<sup>67</sup> *Calvert v. Firststar Fin., Inc.*, 409 F.3d 286, 295 (6th Cir. 2005).

<sup>68</sup> *Id.*

<sup>69</sup> *Metro Life Ins. Co. v. Glenn*, 554 U.S. 105, 117 (2008).

Following *Firestone*, the Eleventh Circuit adopted a six-step burden shifting approach in *Williams* to take a conflict of interest into account.<sup>70</sup> If the plan administrator was vested with discretion, his decision would be upheld if it was not “arbitrary and capricious”.<sup>71</sup> If a conflict of interest existed, then the court would then review under a “heightened arbitrary and capricious” standard.<sup>72</sup> The court stated this standard fell between “de novo” and a regular “arbitrary and capricious” review, although the court could not define exactly where.<sup>73</sup> To deal with this, the court adopted a two-step approach where the burden was on the beneficiary to prove the administrator had a conflict of interest.<sup>74</sup> If proved that he did, the administrator then had the burden of proving that his decision was not tainted by self- interest.<sup>75</sup> The case does seem compatible with *Firestone*, but there is some vagueness to the test because the court did not define a precise standard of review. Of course, this vests the judge with great leeway in making a decision.

### III. METROPOLITAN LIFE INSURANCE COMPANY V. GLENN

The standard articulated by the Supreme Court in *Firestone* had proved inadequate in providing clear guidance to the circuit courts on how to take a conflict of interest into account when reviewing a plan administrator’s discretionary decision to deny a claimant benefits. This resulted in several different approaches by the circuit courts in apparent contravention of some of ERISA’s main goals—creating uniformity and predictability in the law surrounding

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<sup>70</sup> *Williams v. Bellsouth Telecomm., Inc.*, 373 F.3d 1132, 1137-38 (11th Cir. 2004).

<sup>71</sup> *Williams*, 373 F.3d. at 1137-38.

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

<sup>74</sup> *Id.* at 1138.

<sup>75</sup> *Id.*

employee benefit plans. When the Supreme Court heard *Glenn*, it was against this background that the case was considered.

#### A. ISSUE

The Supreme Court decided *Metropolitan Life Insurance Company v. Glenn* on June 19, 2008.<sup>76</sup> This case presented two questions to the court: (1) whether a plan administrator that both evaluates and pays claims operates under a conflict of interest, and (2) how any such conflict should be taken into account on judicial review of a discretionary benefit determination.<sup>77</sup> The facts of the case are set forth below.

#### B. FACTS

In this case, the plaintiff, Wanda Glenn (hereinafter Glenn), was an employee of Sears Roebuck & Company.<sup>78</sup> Sears provided its employees with the option of enrolling in a Group Long-Term Disability Plan, in which Glenn participated.<sup>79</sup> The Metropolitan Life Insurance Company (MetLife) acted as the plan's fiduciary, and made decisions regarding which employees were entitled to benefits.<sup>80</sup> Under the plan, MetLife both reviewed and paid claims. Sears is the plan sponsor and administrator.<sup>81</sup>

In April 2000, Glenn was diagnosed with severe dilated cardiomyopathy, the symptoms of which include fatigue and shortness of breath.<sup>82</sup> Prior to suffering the disease, Glenn had worked as a sales manager from 1994 through 2000.<sup>83</sup> The District

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<sup>76</sup> *Metro. Life Ins. Co. v. Glenn*, 554 U.S. 105, 105 (2008).

<sup>77</sup> *Id.* at 2347.

<sup>78</sup> *Glenn v. Metro. Life Ins. Co.*, No. 2:2003CV0572, 2005 WL 1364625, at \*1 (S.D. Ohio 2005).

<sup>79</sup> *Id.*

<sup>80</sup> *Id.*

<sup>81</sup> *Id.*

<sup>82</sup> *Id.*

<sup>83</sup> *Id.*



Court found that this job involved a considerable amount of standing and walking, as well as some lifting.<sup>84</sup> Because of the cardiomyopathy, Glenn stopped working in April 2000 and applied for disability benefits in June 2000.<sup>85</sup> MetLife approved her claim for disability benefits, which were awarded for a twenty-four month period.<sup>86</sup> These benefits were based on a finding that the employee was “completely and continuously unable to perform the material duties of her regular job.”<sup>87</sup> After the twenty-four month period ended, the employee would have to meet a considerably stricter standard to continue to maintain unemployment benefits: the employee would have to demonstrate that she was “completely and continuously unable to perform the duties of any gainful work or service for which she is reasonably qualified taking into consideration her training, experience, education, and past earning.”<sup>88</sup> Glenn filed for social security disability benefits, but this provided her little relief.<sup>89</sup>

In March 2002, MetLife had Dr. Patel meet with Glenn to reevaluate her status as disabled.<sup>90</sup> After the meeting, the doctor stated that Glenn was capable of performing sedentary work, i.e. work as an office clerk or secretary.<sup>91</sup> Another doctor was consulted

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<sup>84</sup> *Glenn*, 2005 WL 1364625, at \*1.

<sup>85</sup> *Id.*

<sup>86</sup> *Id.*

<sup>87</sup> *Glenn v. Metro. Life Ins. Co.*, 461 F.3d 660, 662 (6th Cir. 2006).

<sup>88</sup> *Id.*

<sup>89</sup> In August 2000, Glenn filed for Social Security disability benefits on the suggestion of the plan administrators. Her request was initially denied but eventually approved by an administrative law judge. She received about \$13,000 from Social Security, but seventy-five percent was recovered by MetLife for “overpayment of benefits” and the other twenty-five percent was recovered by her lawyers. *Id.* at 663.

<sup>90</sup> *Id.* at 664.

<sup>91</sup> *Id.*

and agreed with the assessment by Dr. Patel.<sup>92</sup> Based on this finding, MetLife did not grant Glenn's request for benefits after the twenty-four month period because it was determined that she was capable of performing some work, and thus, could not meet the standard under the second test which required: not only that she was not able to perform her previous job, but also that she was not able to perform any job for which she was reasonably qualified.<sup>93</sup>

Glenn asked MetLife to reconsider its decision.<sup>94</sup> After meeting again with Dr. Patel, he stated that it was his opinion that Glenn was still having "significant difficulty" returning to any type of work because the emotional stress of the job exacerbated her condition.<sup>95</sup> MetLife again decided to discontinue benefits as of September 2002.<sup>96</sup> Interestingly, MetLife seemed to disregard Dr. Patel's findings as of the second meeting and based its opinion on his previous statements that Glenn was able to work. In February 2003, Glenn again appealed submitting a new report from Dr. Patel, dated February 12, 2003, that Glenn was unable to work. MetLife referred Glenn to another doctor who stated that Glenn may be able to work, but if emotional stress exacerbates her condition then permanent disability would be appropriate.<sup>97</sup> Again, MetLife decided to terminate benefits based upon a finding that there was some work that Glenn would be able to perform.<sup>98</sup>

### C. PROCEDURAL HISTORY

The Employee Retirement Income Security Act of 1974 (ERISA) permits a person that is denied benefits to challenge the denial in federal court.<sup>99</sup> The plan in which Glenn participated fell

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<sup>92</sup> *Id.*

<sup>93</sup> *Glenn*, 461 F.3d at 664.

<sup>94</sup> *Id.* at 665.

<sup>95</sup> *Id.* at 664-65.

<sup>96</sup> *Id.* at 664.

<sup>97</sup> *Id.* at 665.

<sup>98</sup> *Id.*

<sup>99</sup> 29 U.S.C. § 1132(a)(1)(B) (2006). *See supra* notes 24-26.

under the jurisdiction of ERISA allowing Glenn to bring suit in a federal court.

After her requests for benefits were denied by MetLife, Glenn brought suit in the United States District Court for the Southern District of Ohio in 2005.<sup>100</sup> Glenn sought reinstatement of her disability benefits under ERISA.<sup>101</sup> Both Glenn and MetLife moved for summary judgment and the court entered judgment in favor of MetLife.<sup>102</sup>

In reaching its decision, the court began by establishing the appropriate standard of review when reviewing an administrator's denial of benefits under ERISA.<sup>103</sup> The court began by applying *Firestone* and determined that the administrator was granted discretionary authority.<sup>104</sup> Under *Firestone*, if the plan grants the administrator deferential authority, the denial of benefits is reviewed under the highly deferential arbitrary and capricious standard.<sup>105</sup> In addition to the standard of review, another issue, one that would eventually be presented to the Supreme Court, was raised in the District Court: how to factor in the "conflict of interest" which is present when administrator is both deciding whether an employee is eligible for benefits and is the one paying the benefits.<sup>106</sup> The district court stated that a conflict of interest is a factor that must be considered under the "arbitrary and capricious" standard.<sup>107</sup> In granting summary judgment for MetLife, the district court stated that the administrator had not acted "arbitrarily or capriciously" in denying benefits because there were doctor's reports that indicated that Glenn was capable of working.<sup>108</sup> Also, the court stated that it

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<sup>100</sup> Glenn v. Metro. Life Ins. Co., No. 2:2003CV0572, 2005 WL 1364625, at \*1 (S.D. Ohio 2005).

<sup>101</sup> *Id.*

<sup>102</sup> *Id.*

<sup>103</sup> *Id.* at \*3-4.

<sup>104</sup> *Id.*

<sup>105</sup> *Id.*

<sup>106</sup> Glenn, 2005 WL 1364625, at \*4.

<sup>107</sup> *Id.*

<sup>108</sup> *Id.* at \*7.

was not arbitrary and capricious to look skeptically on a doctor's report that recanted a previous statement.<sup>109</sup> Based on this finding, the court found that there was a reasoned basis for the administrator's decision and upheld the denial of benefits.

After being denied benefits by the district court, Glenn appealed to the United States Court of Appeals for the Sixth Circuit. The Court of Appeals reversed and remanded the decision of the District Court, stating that the decision of the plan administrator was arbitrary and capricious.<sup>110</sup> The Court of Appeals used the "combination of factors" approach in which a conflict of interest is considered among many other factors in determining if there is an abuse of discretion.<sup>111</sup> The Court first noted that the District Court correctly stated that the plan administrator's conflict of interest was a factor that should be weighed in its decision, but that the District Court seemed to disregard this factor by giving it no weight in its decision.<sup>112</sup> The Court of Appeals also noted that the contrary finding by the Social Security administrator that Glenn was totally disabled should have been given more weight by the District Court and plan administrator.<sup>113</sup> The Court of Appeals noted that MetLife used this finding to deduct the benefits it had paid to Glenn, and then demanded a refund from her which was paid out of her Social Security benefits.<sup>114</sup> The Court of Appeals stated that it was unfair, and inconsistent for MetLife to then give the Social Security administrator's determination no weight in finding that Glenn was not totally disabled.<sup>115</sup> The Court also found that the District Court did not properly consider all of the medical evidence before it and the plan administrator's finding in regard to the medical evidence

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<sup>109</sup> *Id.*

<sup>110</sup> *Glenn v. Metro. Life Ins. Co.*, 461 F.3d 660, 674-75 (6th Cir. 2006).

<sup>111</sup> *Id.* at 665-67.

<sup>112</sup> *Id.* at 666.

<sup>113</sup> *Id.*

<sup>114</sup> *Id.* at 667.

<sup>115</sup> *Id.*

was an abuse of discretion.<sup>116</sup> Essentially, the Court found that the conflict alone was not determinative.<sup>117</sup> It accorded it some weight, but relied on other factors in determining that the plan administrator abused his discretion.<sup>118</sup> Therefore, the Court reversed finding the decision of the plan administrator “arbitrary and capricious” under the “combination of factors” test.<sup>119</sup>

#### D. SUPREME COURT DECISION

After the Court of Appeals ruled in favor of Glenn, MetLife sought certiorari requesting that the Supreme Court determine if a plan administrator who is responsible for determining benefits and paying claims operates under a conflict of interest.<sup>120</sup> Upon suggestion of the Solicitor General, the Supreme Court also considered how any conflict of interest should be taken into account upon judicial review of a discretionary benefit determination.<sup>121</sup>

The case was decided on June 19, 2008 and the opinion was delivered by Justice Breyer, in which Justices Stevens, Souter, Ginsburg, and Alito joined.<sup>122</sup> Chief Justice Roberts concurred in part and concurred in the judgment.<sup>123</sup> Justice Kennedy also filed an opinion concurring in part and concurring in the judgment.<sup>124</sup> Justice Scalia filed a dissenting opinion, which was joined by Justice Thomas.<sup>125</sup>

In answering the questions addressed to the Court, the Court first cited to its decision in *Firestone*.<sup>126</sup> The Court noted that

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<sup>116</sup> *Glenn*, 461 F.3d at 669.

<sup>117</sup> *Id.* at 674.

<sup>118</sup> *Id.*

<sup>119</sup> *Id.* at 674-75.

<sup>120</sup> *Metro. Life Ins. Co. v. Glenn*, 554 U.S. 105, 110 (2008).

<sup>121</sup> *Id.*

<sup>122</sup> *Id.* at 107.

<sup>123</sup> *Id.* at 119 (Roberts, C.J., concurring).

<sup>124</sup> *Id.* at 125 (Kennedy, J., concurring).

<sup>125</sup> *Id.* at 127 (Scalia, J., and Thomas, J., dissenting).

<sup>126</sup> *Metro. Life Ins. Co.*, 554 U.S. at 110.

*Firestone* required that the Court analyze the fiduciary's decision in light of trust law principles.<sup>127</sup> The Court set forth four criteria that a court must consider under *Firestone*.<sup>128</sup> First, a court should be guided by principles of trust law. As applicable here, that means that a court should draw an analogy between a plan administrator and the trustee of a common-law trust, in which common-law trustees have a fiduciary duty of loyalty to those in the trust.<sup>129</sup> The plan administrator's actions must be analyzed in light of the duty of loyalty. Second, principles of trust law require a court to review a denial of plan benefits under a de novo standard, unless the plan provides to the contrary.<sup>130</sup> Third, a plan can provide to the contrary by granting to the administrator a fiduciary discretionary authority to determine benefits.<sup>131</sup> Of course, the administrator is still bound by the duty of loyalty. If the administrator possesses discretion, the denial of benefits will be reviewed under a deferential standard.<sup>132</sup> Fourth, if a conflict of interest exists, the conflict of interest must be weighed as a factor in considering whether there has been an abuse of discretion.<sup>133</sup>

#### E. CONFLICT OF INTEREST

In the lower court decisions, the conflict of interest issue was expressly addressed. First, both the district court and Court of Appeals agreed that there was a conflict of interest in this case based on MetLife's role in both determining and paying benefits. Second, the District Court and Court of Appeals both agreed as to the appropriate standard to apply to the facts. Both courts stated that if there is a conflict of interest, it is to be weighed as a factor in

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<sup>127</sup> *Id.* at 111.

<sup>128</sup> *Id.*

<sup>129</sup> *Id.*

<sup>130</sup> *Id.*

<sup>131</sup> *Id.*

<sup>132</sup> *Metro. Life Ins. Co.*, 554 U.S. at 111.

<sup>133</sup> *Id.*

determining whether there has been an abuse of discretion.<sup>134</sup> However, the lower courts differed in their application of the standard. The Court of Appeals stated that the District Court did not apply any weight to MetLife's conflict of interest.<sup>135</sup> This was an important factor in the Court of Appeals reversal of the district court decision.

In addressing this issue, the Supreme Court first stated that a "conflict of interest" does occur when an administrator is responsible for both determining benefits and paying benefits.<sup>136</sup> The Court noted that the conflict of interest results from the administrator being torn between fulfilling its fiduciary duty of loyalty to the plan beneficiaries and protecting the company's financial interest.<sup>137</sup> The administrator has a duty of loyalty to grant all claims to which the beneficiaries are entitled.<sup>138</sup> But, every dollar paid in benefits comes out of the administrator's profits. Therefore, the court reasoned, in close calls especially, the administrator would be torn between fulfilling both of these interests.<sup>139</sup> The Court also stated, in keeping with *Firestone's* holding of analogizing to trust law principles, that this was the type of conflict a court would take into account when reviewing the discretionary acts of a trustee.<sup>140</sup>

In arguing that the plan administrator was not conflicted, MetLife raised various arguments. First, MetLife argued that an employer who creates a plan where the administrator will act in the dual role of determining and dispensing benefits foresees this potential conflict, and implicitly approves it.<sup>141</sup> The Court disposed of this argument rather quickly, by analogizing to trust law, stating

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<sup>134</sup> See *supra* notes 92-109.

<sup>135</sup> See *supra* notes 102-109.

<sup>136</sup> *Metro. Life Ins. Co.*, 554 U.S. at 112.

<sup>137</sup> *Id.*

<sup>138</sup> *Id.*

<sup>139</sup> *Id.*

<sup>140</sup> *Id.* at 112-13.

<sup>141</sup> *Id.*

that even when the settlor knows the trustee is conflicted, the reviewing court must still take account of the conflict.<sup>142</sup>

Second, MetLife argues that the court is not required to follow principles of trust law if it conflicts with the language, structure, or purpose of the governing statute, in this case ERISA.<sup>143</sup> MetLife stated that finding a conflict is inconsistent with the statute's objectives because it would result in increased litigation through complex review proceedings, deter employers from creating plans, and interfere with employer's right to administer their own plans in violation of ERISA.<sup>144</sup> Again, the Court dismissed these concerns rather quickly stating that they were not inconsistent with the statute.<sup>145</sup> The Court noted that trust law "functions well with a similar standard", and there was no evidence that the rule adopted by the Court would have a chilling effect on benefit plans.<sup>146</sup> Ultimately, the Court relied on Congress' desire to offer employees increased protection for work-related benefits<sup>147</sup> to offset the factors named by MetLife.

The Court did give considerable attention to MetLife's argument that the conflict was acceptable because any business has to make decisions regarding a trade-off between profit and service, and insurance companies should not be an exception. MetLife argued that the market, as well as regulators, provides sufficient checks on MetLife's handling of discretionary claims.<sup>148</sup> If MetLife were to deny too many claims, it would only be hurting itself as employers and employees would switch to the service of a different company. The Court did not explicitly reject this argument; however, it found that a conflict of interest did exist under ERISA for several reasons. First, the Court noted that the presumption that the market will provide a sufficient check is weakened because the

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<sup>142</sup> *Metro. Life. Ins. Co.*, 554 U.S. at 113.

<sup>143</sup> *Id.*

<sup>144</sup> *Id.*

<sup>145</sup> *Id.*

<sup>146</sup> *Id.*

<sup>147</sup> *Id.* at 114.

<sup>148</sup> *Id.*



employer purchases the plan instead of the employee.<sup>149</sup> The Court noted that the employer may have incentives to choose the insurer who provides lower rates by being stingier in granting claims. Thus, the Court reasoned that the marketplace argument does not work perfectly in this situation.<sup>150</sup> However, the Court ignored the fact that the employees could leave a company that provided insufficient benefit plans, so the market argument does still carry some weight (assuming employees are perfectly informed). However, its force is reduced because of the difficulty in finding a new job, especially considering the historically high unemployment rate of 9.6% in late 2010.<sup>151</sup> So while the “marketplace argument” is not totally discredited, its force is significantly undermined by the disconnect between the employee and the choice of insurer.

Second, the Court noted that “ERISA imposes higher-than-marketplace quality standards on insurers.”<sup>152</sup> The Court cites to *Firestone*, which stated that, under 1104(a)(1) of ERISA, that the administrator must “discharge his duties. . . solely in the interests of the participants and beneficiaries” of the plan.<sup>153</sup> The statute also requires that a full and fair review be given to all claim denials.<sup>154</sup> Also, judicial review of claim denials provides an additional check in addition to those provided by the marketplace and regulators.<sup>155</sup> Here, the Court notes the difference in the duties imposed on the insurance company regulated under ERISA from the duties imposed on the normal market participant. Obviously, a normal market participant does not have to act for the sole interest of his customers and is free to balance his own interests with those he serves, subject to the checks placed on his conduct by the market. So while the

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<sup>149</sup> *Id.*

<sup>150</sup> *Id.*

<sup>151</sup> BUREAU OF LABOR STATISTICS, ECONOMIC NEWS RELEASE, UNEMPLOYMENT SITUATION SUMMARY (Sept. 2010) <http://www.bls.gov/news.release/empsit.nr0.htm>

<sup>152</sup> *Glenn*, 554 U.S. Ct. at 115.

<sup>153</sup> *Id.*

<sup>154</sup> *Id.*

<sup>155</sup> *Id.*

market can provide on check on the discretion of the administrator, under ERISA more is required. The duty to act solely in the interest of one's customers goes far beyond the burden placed on any other unregulated market participant.

Finally, the Court noted that the factors advanced by MetLife as diminishing the unfairness of any conflict of interest can be taken under consideration by any reviewing body or court.<sup>156</sup> So, a court can consider any countervailing influences to the administrator's desire to act in the financial interest of his company.

The issue considered whether a conflict of interest existed was not an area of much controversy in the law prior to the case, and all of the Justices agree that a conflict of interest was present. In fact, in many cases the employer would be willing to submit that a conflict of interest existed and contest the appropriate standard of review. The standard of review was much more unsettled, as evidenced by the circuit split. That point is addressed next.

#### F. STANDARD OF REVIEW

Next, the Court addressed the question of how the existence of a conflict of interest should be taken into account by a court on review. In answering this question, the Court relied on a statement set forth in *Firestone*: "[A] conflict should be weighed as a 'factor in determining whether there has been an abuse of discretion.'"<sup>157</sup> The Court stated it did not want to overrule *Firestone*, and Court reaffirmed *Firestone*'s reliance upon trust law principles.<sup>158</sup> The court stated that *Firestone* simply restated established trust law principals in affirming a deferential standard of review to an administrator who is given discretion.<sup>159</sup> The Court stated that under current trust law, a "deferential standard is applied to the discretionary decision-making of a conflicted trustee, while at the same time requiring the reviewing judge to take account of the

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<sup>156</sup> *Id.*

<sup>157</sup> *Glenn*, 554 U.S. at 115.

<sup>158</sup> *Id.* at 116.

<sup>159</sup> *Id.*

conflict when determining whether the trustee, substantively or procedurally, has abused his discretion.”<sup>160</sup>

The Court declined any invitation to adopt a *de novo* standard of review to any administrator given discretion, stating that it would be inappropriate for several reasons.<sup>161</sup> First, the Court noted that many ERISA plans that require the administrator to assess payments and provide payment grant discretionary authority to the administrator.<sup>162</sup> Since most claim denials occur under these types of plans, the court thought it unwise and unmanageable for reviewing courts to look at all of these claims *de novo*.<sup>163</sup> Second, the Court stated that Congress made no mention of any standard of review in enacting the ERISA legislation.<sup>164</sup> The Court reasoned that if Congress wanted a specific standard of review, it would have specifically stated it in the legislation.<sup>165</sup> Because a *de novo* standard creates a greater burden on any reviewing court, the Court seems to be implying that Congress would have stated its desire for *de novo* review had it wanted one.

Next, the Court appears to reject the “presumptively void” test, stating that there is no need for the creation of “special burden of proof rules, or other special procedural or evidentiary rules”.<sup>166</sup> The Court stated that this is a very fact sensitive inquiry because of the differences likely to be present in most situations, and the

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<sup>160</sup> *Id.* at 115.

<sup>161</sup> “We do not believe Firestone’s statement implies a change in the standard of review, say, from deferential to *de novo* review.” *Glenn*, 554 U.S. at 115.

<sup>162</sup> *Id.* at 116.

<sup>163</sup> *Id.*

<sup>164</sup> *Id.*

<sup>165</sup> *Id.*

<sup>166</sup> *Id.* at 116. The Court never makes no reference to the “presumptively void” test or cites to any of the cases which hold follow it. But, the Court’s statement that there is no need for any strict rules or rebuttable presumptions leaves little is a strong indication that the “presumptively void” test is no longer valid.

presence of a conflict is just one factor to be weighed.<sup>167</sup> The Court stated that if the insurer had taken steps to prevent the conflict of interest from playing a role in the administrator's decision, then this factor may not play much of a role in the reviewing court's determination.<sup>168</sup> Examples of this would be making sure those determining the validity of claims had no incentives to consider the firm's interest in making a profit.<sup>169</sup>

The Court concludes by stating, essentially, that because there are so many factors that play a role in determining whether an administrator's judgment is fair, it is impossible to articulate a precise standard.<sup>170</sup> The Court states that a rigid standard or procedure would improvidently restrict court's discretion in dealing with many different factual scenarios.<sup>171</sup> Essentially the Court is acknowledging that no standard can substitute for the process of judgment. Ultimately, the conflict of interest must be considered along with any other relevant factors (i.e. whether the Social Security administrator had a complete record in front of him at the time the decision was made or whether MetLife took steps so that its administrator would not be inclined to consider the firm's profits during his decision making process) to determine if the administrator abused his discretion.<sup>172</sup> The court acknowledged that this standard "did not consist of a detailed set of instructions" in keeping with its position that the creation of such a standard would be unwise.<sup>173</sup> The Court acknowledges the limits of these standards in that they can

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<sup>167</sup> *Glenn*, 554 U.S. at 117.

<sup>168</sup> *Id.*

<sup>169</sup> One solution is to pay the administrator a fixed salary that is not dependent on the firm's profit or the administrator's record in denying or approving claims.

<sup>170</sup> *Id.* at 117. (The Court noted it had not articulated a precise standard and stated that it is not wise to create formulas that will "falsify the actual process of judging." "There are no talismanic words that can avoid the process of a judgment." *Id.* at 119.)

<sup>171</sup> *Glenn*, 128 S. Ct. at 116.

<sup>172</sup> *Id.* at 117.

<sup>173</sup> *Id.* at 119.

restrict a judge's inquiry because they are incapable of allowing a judge to take account of all relevant factors all of the time.<sup>174</sup> Ultimately, the Supreme Court holds that a court should review a denial of benefits by an administrator given discretion under an abuse of discretion standard, and that any conflict of interest must be taken into account, but leaves the amount of weight it carries up to the reviewing court.<sup>175</sup> Additionally, the Court rejected the argument that there is a change in the standard of review from deferential to de novo.<sup>176</sup> The weight the conflict is given will be a fact sensitive inquiry, depending upon how much the court determines that the conflict factored into the decision.

#### G. CHIEF JUSTICE ROBERTS CONCURRENCE

Chief Justice Roberts agrees that an insurer who both determines benefits and pays claims has a conflict of interest that is "pertinent" in reviewing claims decisions.<sup>177</sup> However, Chief Justice Roberts disagrees with the majority as to how much it should matter. Chief Justice Roberts believes that the presence of a conflict of interest should only be considered if there is evidence suggesting the conflict affected the administrator's decision.<sup>178</sup> Under this standard, the court would be looking to see if an "improper motive" played a role the administrator's denial of benefits, not just to the potential for an improper motive.<sup>179</sup>

Chief Justice Roberts is worried that the majority standard will prove to be too unpredictable because of the amount of

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<sup>174</sup> *Id.* at 116

<sup>175</sup> *Id.* at 117-18.

<sup>176</sup> *Id.* at 115..

<sup>177</sup> *Glenn*, 554 U.S. at 119-26. (Roberts, C.J. concurring in all but Part IV and concurring in the judgment). Part IV of the Opinion discussed how a conflict of interest should be factored into the review of a claim decision.

<sup>178</sup> *Id.* at 119-20.

<sup>179</sup> *Id.* at 122-23.

discretion it gives to a reviewing court.<sup>180</sup> Chief Justice Roberts worries that the majority standard will simply act to substitute judicial discretion for that of the administrator. This is even more worrisome to him because the judge is removed from the actual proceedings and is given a large amount of discretion.<sup>181</sup> He notes that important criteria of ERISA were predictability and certainty and he explains that the Court's indeterminate standard strays from these policy goals.<sup>182</sup> He believes that because the conflict of interest is not given a definitive weight the law is left in an uncertain state. Chief Justice Roberts reasons that this will lead to fewer companies deciding to create employee benefits plans because the companies will be unsure about the law and the potential costs of liability.<sup>183</sup> For Chief Justice Roberts, the increase in costs (in terms of uncertainty) does not outweigh any benefits that stem from increased judicial flexibility.

Ultimately, Chief Justice Roberts would uphold the decision of the Court of Appeals.<sup>184</sup> Even though he does not believe there is any evidence that the conflict of interest played a role in the administrator's decision, Chief Justice Roberts believes that the plan administrator still abused his discretion.<sup>185</sup> He states that the administrator's inconsistent position in regard to the Social Security determinations and the lack of consideration to doctor's reports stating that Glenn should not work and its failure to provide its own experts with certain doctor's testimony are all evidence of an abuse of discretion—but not evidence that a improper financial interest played a role in the administrator's decision.<sup>186</sup> For this reason, Chief Justice Roberts states that the decision of the Court of Appeals should be affirmed.

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<sup>180</sup> *Id.* at 121.

<sup>181</sup> *Id.* at 121-22.

<sup>182</sup> *Id.* at 122.

<sup>183</sup> *Id.*

<sup>184</sup> *Id.* at 125.

<sup>185</sup> *Id.* at 124-25.

<sup>186</sup> *Id.* at 123-24.

#### H. JUSTICE KENNEDY'S CONCURRENCE.

Kennedy believes that the majority has correctly applied the *Firestone* decision and that framework set out by the Court is workable.<sup>187</sup> Kennedy states that the framework set out by the Court will not undermine the control of dual-role administrators over the employee benefit plans because the conflict of interest will not be considered by the court if the insurer takes the appropriate safeguards.<sup>188</sup> Because the administrators retain control, the incentive system for the creation of these plans will not be altered much.

Kennedy believes the case should have been remanded to the Court of Appeals because the Court stated that the conflict of interest can vanish as a factor to be considered if the insurer can show it put in place safeguards so that the administrator would not consider the financial interests of his employer.<sup>189</sup> Because MetLife was unaware of this, it did not present any evidence that it put in place the appropriate safeguards.<sup>190</sup> Kennedy states that it is unfair to MetLife to have expected it to put forth evidence regarding any safeguards because it had no notice of the relevance of those safeguards.<sup>191</sup> For those reasons, Justice Kennedy would remand the decision to the Court of Appeals.

#### I. JUSTICE SCALIA'S DISSENT

Scalia begins by stating that he agrees that a conflict of interest exists because the plan administrator pays benefits out of its

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<sup>187</sup> *Glenn*, 554 U.S. at 125-27. (Kennedy, J. concurring in all but Part IV of the Court's opinion and dissenting in part).

<sup>188</sup> *Id.* at 125-26.

<sup>189</sup> *Id.*

<sup>190</sup> *Id.* at 126.

<sup>191</sup> *Id.*

own coffers.<sup>192</sup> After that, he parts ways with the majority stating that he is in “fundamental disagreement” with the majority approach.<sup>193</sup> His dissent, joined by Justice Thomas, addresses several points.

First, he states that the majority approach is too unpredictable.<sup>194</sup> Scalia states that the majority approach makes each case unique because any number of different factors must be considered and weighed, depending upon the circumstances.<sup>195</sup> In addition, each factor can be different weights from case to case, making ruling unpredictable.<sup>196</sup>

Second, Scalia believes that the conflict should not be considered unless there is evidence to indicate that the conflict of interest improperly motivated the administrator’s decision.<sup>197</sup> He states that the part of the *Firestone* opinion stating that a conflict must be considered as a factor when an administrator is vested with discretion is “sheer dictum” because the administrator in *Firestone* was not conflicted.<sup>198</sup> Therefore, the court never had the opportunity to consider the standard of review for an administrator with discretion.<sup>199</sup> While he does believe the Court must be guided principles of trust law, Scalia believes that the Court has misapplied trust law in an effort to reconcile the Restatement with the dictum in *Firestone*.<sup>200</sup> Accordingly, Scalia would adopt the entirety of the Restatement “and its clear guidelines for judicial review.”<sup>201</sup> Abuse of discretion, as he interprets it, refers to four *distinct* (emphasis added) failures; the trustee acted dishonestly; he acted with some

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<sup>192</sup> *Glenn*, 554 U.S. at 127-134 (Scalia, J., with whom Thomas, J., joins, dissenting).

<sup>193</sup> *Id.* at 127.

<sup>194</sup> *Id.*

<sup>195</sup> *Id.*

<sup>196</sup> *Id.*

<sup>197</sup> *Id.* at 127-28.

<sup>198</sup> *Glenn*, 554 U.S. at 128.

<sup>199</sup> *Id.*

<sup>200</sup> *Id.* at 129.

<sup>201</sup> *Id.* at 130.



other improper motive; he failed to use judgment; or he acted beyond the bounds of a reasonable judgment.<sup>202</sup> Scalia emphasizes that these are distinct and separate abuses, and so should be considered separately in contrast to the majority opinion which allows all relevant factors to be considered and weighed at once.<sup>203</sup> Scalia takes issue with the majority's approach of simply taking a conflict under consideration with all factors and giving it varying amount of discretion depending upon the facts.<sup>204</sup> He believes it to be too unpredictable and "opaque".<sup>205</sup> His solution, adoption of the Restatement, requires the four distinct abuses to be weighed separately<sup>206</sup>—not "chucked into a brown paper bag and shaken up to determine the answer".<sup>207</sup> This certainly clarifies how the judge reached his decision—over time this would likely lead to increased predictability. Essentially, Scalia is arguing for limiting the judge's discretion and increased disclosure on how the judge reached his decision.

As a final point, Scalia argues that a conflict should not be considered unless there is evidence that the trustee acted with an improper motive.<sup>208</sup> If a trustee makes a reasonable decision, then it should not be overturned because of the presence of a conflict of interest, even if the court believes a better decision could have been made.<sup>209</sup> Scalia is worried that a trustee will avoid a decision that he believes to be in the best interests of the beneficiaries because it may appear that the conflict affected his decision, and choose a decision

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<sup>202</sup> *Id.* at 131. A trustee abuses his discretion by acting on an improper motive when he acts 'from a motive other than to further the purposes of the trust'. Improper motives include 'spite or prejudice or to further some interest of his own other than that of the beneficiary.' RESTATEMENT (THIRD) OF TRUSTS § 50 (2003).

<sup>203</sup> *Glenn*, 554 U.S. at 131-32.

<sup>204</sup> *Id.* at 129-30.

<sup>205</sup> *Id.*

<sup>206</sup> *Id.* at 129.

<sup>207</sup> *Glenn*, 554 U.S. at 129.

<sup>208</sup> *Id.* at 132.

<sup>209</sup> *Id.* at 133.

that looks less self-serving.<sup>210</sup> Accordingly, he states “there are no gradations of reasonableness...[r]easonable is reasonable...[g]radating reasonableness, and making it a ‘factor’ in the improper motive determination will have the precise effect of eliminating the discretion the settler has intentionally conferred upon the trustee.”<sup>211</sup> Scalia is apparently worried that the majority’s standard will restrict the administrator’s discretion to the detriment of the beneficiaries because it gives so much leeway to the reviewing court.<sup>212</sup>

#### IV. CIRCUIT COURT APPROACHES FOLLOWING GLENN

Following *MetLife*, almost every Circuit has addressed the question of how to apply the ruling in the *MetLife* case. Overall, it appears the ruling has produced greater uniformity among the Courts than prior to the decision. Still, there is certainly a considerable amount of uncertainty among several of the Circuit as to exactly how the ruling should be applied.

All Circuit Courts to consider the matter have applied a combination-of-factors type of review after *Glenn*, even they do not explicitly call it that in their opinion.<sup>213</sup> In this regard, there is little

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<sup>210</sup> *Id.* at 132.

<sup>211</sup> *Id.* at 133.

<sup>212</sup> *Id.* at 128-30. (Earlier in his dissent, Scalia referred to the majority’s standard as “de novo review in sheep’s clothing.” *Id.* at 130.).

<sup>213</sup> See *Crowell v. Shell Oil. Co.*, 541 F. 3d. 295, 312 (5th Cir. 2008) (“...we [must] ‘take account of several different considerations, of which a conflict of interest is one’”); *Estate of Schwing v. The Lilly Health Plan*, 522, 525 (3d Cir. 2009) (holding that a court must “consider a conflict of interest as one of several factors in determining whether an administrator of fiduciary abused his discretion”); *Wakkinen v. UNUM Life Ins. Co. of Am.*, 531 F. 3d 575, 581 (8th Cir. 2008) (“any one factor will be considered as a tie-breaker when the other factors are closely balanced” (*citing Glenn*, 128 S. Ct at 2350). *Holcomb v. UNUM Life Insurance Co. of*

conflict that a conflict of interest is factor that must be weighed among any other relevant factors to determine if there is an abuse of discretion. The main source of controversy is how the conflict is to be weighed by the judge. That matter is addressed next.

While the circuit court approaches in regard to the standard of review are not identical after *Glenn*, there does seem to be much more uniformity. *Glenn* held that when a conflict is present, there is no change in the standard of review from deferential to de novo; rather a conflict should be considered as a relevant factor and given more weight depending upon the circumstances.<sup>214</sup> From this, almost all circuits have concluded that a heightened review when a conflict is present would be incompatible with *Glenn*.<sup>215</sup> The sliding scale

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Amer., 578 F. 3d. 1187, 1193 (10th Cir. 2009) (“*Glenn* embraces a ‘combination-of-factors method of review’ that allows judges to ‘take account of several different, often case-specific factors.’” (citing *Glenn*, 128 S. Ct. at 2351)); Carden v. Aetna Life Ins. Co., 559 F. 3d 256,260 (4th Cir. 2009). (“a conflict just becomes one of the ‘several different, often case-specific factors’ to be weighed together to determine if the administrator abused his discretion” (citing *Glenn*, 128 S. Ct. at 2351)).

<sup>214</sup> See *supra* notes 168-74.

<sup>215</sup> See *Holland v. Int’l Paper Co.* 576 F. 3d. 240, 248 (5th Cir. 2009) (stating that *Glenn* directly repudiated the application of any form of heightened review when a conflict of interest is present). See also *Abatie v. Alta Health & Life Ins. Co.* 458 F. 3d 955, 967 (9th Cir. 2006) (claiming their approach was a “conscious rejection” of the sliding scale approach); *Estate of Schwing v. The Lilly Health Plan*, 522, 525 (3d Cir. 2009) (holding that “in light of *Glenn*, our ‘sliding scale’ approach is no longer valid); *Champion v. Black & Decker Inc.*, 550 F. 3d 353, 358-59 (4th Cir. 2008); (holding that after *Glenn*, “the consequence of this finding [of a conflict of interest] is not to modify the standard of review, but rather to consider the conflict as but one among factors in determining the reasonableness of the plan’s discretionary determination”); *Doyle v. Liberty Life Assurance Co. of Boston*, 542 F. 3d. 1352, 1359-60 (11th Cir. 2008) (holding that *Glenn* implicitly overrules and

approach requires a court to adjust the *level of deference* depending upon how much the conflict factored into the decision, and *Glenn* requires a court to adjust the *amount of weight* given to the conflict while maintaining an abuse of discretion review. Therefore, almost all circuit courts to consider the issue have found the sliding scale approach incompatible with *Glenn*. The Third, Fourth, Fifth, Ninth, and Eleventh Circuits have all found the sliding scale approach incompatible with the standard in *Glenn* because it requires a heightened standard of review.<sup>216</sup>

The Ninth Circuit “consciously rejected” the sliding scale approach in *Abatie*,<sup>217</sup> which was decided before *Glenn*. In *Montour*, the Ninth Circuit stated that it has employed the *Glenn* standard by using an abuse of discretion review, and including a conflict of interest as a factor to be weighed.<sup>218</sup> It then adjusts the weight of the conflict depending upon the circumstances.<sup>219</sup> After stating that it has rejected the sliding scale approach, the court stated that it will adjust the level of skepticism it applies depending upon the facts, including how much a conflict may have tainted an administrator’s decision.<sup>220</sup> The increased level of skepticism sounds very similar to a heightened standard, which most circuits agree is not compatible with *Glenn*. It also sounds similar to a sliding scale approach, which the Ninth Circuit rejected in *Abatie*. Ultimately, it is difficult to reconcile a purported rejection of the sliding scale approach with using varying

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conflicts with [their] precedent to the extent that it requires district courts to review benefit determinations by a conflicted administrator under a heightened standard of review); *Wakkinen v. UNUM Life Ins. Co. of Am.*, 531 F. 3d 575, 581 (8th Cir. 2008) (“the existence of a conflict did not lead the court to...a change in the standard of review).

<sup>216</sup> See *supra* note 214.

<sup>217</sup> *Abatie*, 458 F. 3d at 967.

<sup>218</sup> See *Montour v. Hartford Life & Accident Ins. Co.*, 588 F. 3d 623, 632 (9th Cir. 2009).

<sup>219</sup> *Id.*

<sup>220</sup> *Id.*

amounts of skepticism dependent on the presence of a conflict. It remains to be seen how this will be resolved.

The Tenth Circuit found that the sliding scale approach mirrored the Supreme Court's approach in *Glenn*.<sup>221</sup> The Tenth Circuit stated that the conflict of interest must be incorporated as a factor to be weighed upon review.<sup>222</sup> The court found that the best way to incorporate the conflict of interest factor is a sliding scale approach where the court will always review under an arbitrary and capricious standard, but decrease or increase the level of deference in proportion to the seriousness of the conflict.<sup>223</sup> This is certainly in direct opposition to the approach taken by the other circuits, and seems to contradict with *Glenn*'s language of not changing the standard of review.

In *Doyle*, the Eleventh Circuit adopted the Glenn standard by stating that a heightened review was not compatible with Glenn.<sup>224</sup> It then rejected arguments that, after *Glenn*, a court must give greater weight to the existence of a conflict if there is no evidence the administrator put safeguards in place to assure accurate claim assessment.<sup>225</sup> The court also rejected arguments that the burden was on the administrator to bring forth evidence of safeguards—such that if the administrator brought forth no evidence, this would weigh against them in the test.<sup>226</sup> The Court rejected these arguments “as the type burden shifting rule the Glenn court rejects.”<sup>227</sup> The Court stated that if there is no evidence regarding safeguards, then the court should simply focus on other factors—not hold it against the administrator.<sup>228</sup> The court also rejected an argument that the conflict

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<sup>221</sup> Weber v. GE Life Assurance Co., 541 F. 3d. 1002, 1010-11 (10th Cir. 2008).

<sup>222</sup> *Id.* at 1010.

<sup>223</sup> *Id.* at 1010-11.

<sup>224</sup> Doyle v. Liberty Life Assurance Co. of Boston, 542 F. 3d. 1352, 1359-60 (11th Cir. 2008).

<sup>225</sup> *Id.* at 1362.

<sup>226</sup> *Id.*

<sup>227</sup> *Id.*

<sup>228</sup> *Id.*

should be given greater weight when an administrator places greater weight on medical evidence denying a disability than those affirming a disability.<sup>229</sup> The court simply stated that an administrator's preference for "objective medical evidence" did not entitle the beneficiary to a higher standard of review.<sup>230</sup> This ruling is consistent with Glenn's holding that there is no need to establish any type of burden shifting rules.

The Seventh Circuit has struggled with the application of the standard of review after *Glenn*. Initially, the Seventh Circuit seemed to adopt the combination of factors test in *Glenn*.<sup>231</sup> Then, in *Marrs*, the Court took a step back and noted that "there are two ways to read the majority opinion."<sup>232</sup> One is a combination of factors approach which has been adopted by several of the other circuits, including apparently, the Seventh Circuit. There a conflict is considered and weighed among many other factors, depending upon the circumstances of the case. However, the Judge Posner, in writing the opinion, expressed discomfort with this standard, stating that it "sounds like a balancing test which unweighted factors are mysteriously weighed...[s]uch a test is not conducive to providing guidance to courts or plan administrators."<sup>233</sup> The Seventh Circuit then stated that this "rudderless balancing test did not have to be the final word" on the standard that should be applied by [courts and plan administrators].<sup>234</sup> Accordingly, the court devised a more "directive" approach in which a reviewing court looks to the "gravity" of the conflict, and the likelihood it influenced the administrator's decision—not just the presence of a conflict as the Supreme Court seemed to require.<sup>235</sup> The "gravity" of the conflict is inferred from the circumstances of the case, including the

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<sup>229</sup> *Id.*

<sup>230</sup> *See* Doyle, 542 F. 3d. at 1362.

<sup>231</sup> *Jenkins v. Price Waterhouse Long Term Disability Plan*, 564 F.3d 856, 861 (7th Cir. 2009).

<sup>232</sup> *Marrs v. Motorola Inc.*, 577 F.3d 783, 788 (7th Cir. 2009).

<sup>233</sup> *Marrs*, 577 F. 3d at 788.

<sup>234</sup> *Id.* at 789.

<sup>235</sup> *Id.*

reasonableness of the administrator's procedures and any safeguards set up by an employer.<sup>236</sup> The main modification of the test in this case is the focus on the "gravity" of the conflict instead of its bare existence. The Seventh Circuit is clearly uncomfortable with the *Glenn* test because it does not assign a specific weight to factors or even state what factors must be considered. To remedy this, it focuses on the things that are easier to quantify, like "safeguards" and "administrative procedure" to determine the weight of the conflict. This still gives a lot of discretion to the reviewing court, but the focus on specific factors will seem to force more disclosure remedying some of the "mystery" the Seventh Circuit found unsettling in the *Glenn* test.

The First Circuit stated that a combination-of-factors-test is the appropriate test after *Glenn*, and also slightly modified its approach after *Glenn*.<sup>237</sup> Previously, it had used an approach where a court could disregard a conflict of interest without more based on the market forces approach. If a conflict of interest was present without more, it could be disregarded based on the theory that market forces would restrain the administrator from abusing his power. The court based this on the rationale that an employer would not contract with an insurer with a "reputation for miserliness." If it did, the employer would risk losing employees. After *Glenn*, the First Circuit noted that a conflict must be given some weight regardless of the present of "market forces."<sup>238</sup> Overall, the *Glenn* ruling has resulted in a greater uniformity of approaches by the circuit courts. But, as stated above, differences still persist. The standard in *Glenn* does not provide much guidance as to how exactly a court should consider and weigh the many factors it takes into account upon review, and this is largely the reason why different approaches live on.

## V. ANALYSIS

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<sup>236</sup> *Id.*

<sup>237</sup> *Denmark v. Liberty Life Assurance Co. of Boston*, 566 F. 3d 1, 8 (1st Cir. 2009). (holding that the combination-of-factors test was the appropriate test after *Glenn*).

<sup>238</sup> *Id.* at 9.

*Metropolitan Life v. Glenn* represents a battle between two approaches to judicial review: The first approach states that judges should be given a large amount of flexibility in making a decision so that they can take account of all relevant factors in each individual case. Attempting to delineate a precise standard will result in an unnecessary limit on judge's discretion because no standard can possibly account for all possible scenarios. On the other hand, an imprecise and vague standard gives judge's far too much discretion and makes it difficult to understand their decisions. This decreases predictability, which leads the dissent to advocate a more predictable and open standard which makes it easier to understand judge's decisions.

As stated above, one of the central purposes of enacting ERISA was to increase predictability and uniformity<sup>239</sup>, and the decision in *Glenn* should be evaluated against this backdrop. In this regard, the decision certainly makes the law more predictable, as the circuit courts approach is more uniform than it was pre-*Glenn*. All circuit courts to consider the matter use a combination-of-factors type of review.<sup>240</sup> Almost all circuits, aside from the Tenth, now agree that heightened scrutiny is not compatible with *Glenn*.<sup>241</sup> So, while some differences remain, it is clear the *Glenn* decision has moved the circuit courts into adopting a more uniform approach, and hence more predictable approach.

While the approach is more predictable, individual outcomes are not. Could the decision-making process could be made more predictable? Probably, and this could be done by adopting a more uniform, albeit less flexible standard as Scalia argues in his dissent.<sup>242</sup> Adoption of the Restatement on this matter would provide a more predictable approach because: 1) it provides less flexibility to judges; and 2) a conflict is only considered if there is evidence that the conflict *actually resulted* in the decision being made by an improper

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<sup>239</sup> See *supra* notes 8-25.

<sup>240</sup> See *supra* note 203

<sup>241</sup> See *supra* notes 151-68.

<sup>242</sup> See *supra* notes 187 -202.



motive, i.e. consideration of the plan administrator's financial interest. This is same point on which the seventh circuit struggled in *Marrs*.<sup>243</sup> It was clearly uncomfortable with factors being given an indeterminate weight and then being "mysteriously weighed." If the Supreme Court had accorded specific weights to a number of factors, in say, a multi-factor balancing test it would likely have increased disclosure by judges, while at the same time limiting their discretion. And this would of course increase predictability because it would be easier to tell how most judges made their decisions.

But another goal of ERISA was to provide increased protection to employees, and on balance, it seems that the Supreme Court's test does comport with this statutory goal. By providing increased flexibility to judges, the Supreme Court allows judges to take account of any factors that may have affected an administrator's determination. Also, because it may be difficult to prove a conflict affected an administrator's decision, allowing a court to take account of the bare existence of a conflict certainly protects employees. Scalia would not overturn any decision that is reasonable<sup>244</sup>, but as the seventh circuit noted, both a decision in favor of and in denial of benefits, may be reasonable, and so the administrator's unconscious bias may push him to deny the benefits.<sup>245</sup> Because evidence that the conflict actually affected the decision may be difficult to obtain, allowing consideration of the conflict increases employee protection. On the other hand, the decreased predictability of this standard may result in the creation of fewer employee benefit plans.

Overall, the majority approach, concurrence by Chief Justice Roberts, and the dissent by Scalia all seem to seek the goal of benefiting plan beneficiaries. They simply disagree on how to do so. The majority opinion would give judge's increased flexibility to take a conflict of interest into account—this helps beneficiaries because any conflict will always be allowed to be taken into account by the judge and any conflict will weigh in favor of the beneficiary. But Chief Justice Roberts worries that the increased uncertainty resulting

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<sup>243</sup> *Marrs*, 577 F. 3d 783.

<sup>244</sup> *See supra* notes 200-201.

<sup>245</sup> *Marrs*, 577 F. 3d at 789.

from the indeterminate weight given to the conflict will lead to the creation of less employee benefit plans. He understands that increased unpredictability is equivalent to increased risk and therefore, increased costs.<sup>246</sup> If one assumes that employers are risk averse, this is an economically sensible analysis. If they are risk averse, employers will dislike the possibility of a ruling against them more than they will like the possibility of a ruling for them. Essentially, the argument is that employers would prefer have an exact standard to taking a 50-50 chance where they could end up better or worse off. If employers are risk-averse, and the majority standard leads to increased unpredictability, then Chief Justice Roberts may be correct that less employee benefit plans will be created. Scalia's dissent also seeks increased predictability, which as explained above, would help promote the creation of employee benefit plans or at least maintain the current number of employee benefit plans.

Finally, the prevalence of the benefit plans at issue has grown rapidly. As stated earlier there are currently about 131 million Americans enrolled in employee benefit plans.<sup>247</sup> Of course, these leads to a multitude of factual scenarios that must be considered upon review by judges. In this regard, the flexible standard stated by the majority is the better standard. As the majority recognized, no standard can take account of all relevant factors, and so it is better to allow judges flexibility in making this determination.

## VI. CONCLUSION

Ultimately, the majority decision was the correct decision. The flexibility it provides to a reviewing court that is forced to take account of a wide range of factual scenarios combined with the protection it provides to employees by allowing a conflict to be taken into account regardless of whether evidence can be produced

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<sup>246</sup> If one does not accept the proposition that increased uncertainty to employers is equivalent to increased costs, then the analysis is not compelling.

<sup>247</sup> See *supra* note 1.

outweigh the increased predictability of a more rigid standard. Because the majority approach seems to better reflect the reality that benefit decisions are very complicated and the reality that evidence proving a conflict provided an improper motive is difficult to obtain, it is on balance the better approach.

## FRONTING ARRANGEMENTS: INDUSTRY PRACTICES AND REGULATORY CONCERNS

Esteban Carranza-Kopper\*

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*During the past decades, there have been multiple discussions on the issue of fronting arrangements. In general terms, a fronting arrangement can be considered as an alternative risk transfer method (ART)<sup>1</sup> where an insurer licensed in a certain jurisdiction (fronting insurer) issues a policy to cover local risks but all or virtually all of such risks are then ceded or reinsured with an unlicensed carrier (reinsurer), who will normally take over the administration of all claims related to the risks.<sup>2</sup> In exchange for its services, the fronting company normally receives a small percentage of the total premium.<sup>3</sup> It can be said, therefore, that the fronting company issues a policy and appears to the world to be an insurer, but in reality it has actually passed on to a given reinsurer most or all of the risk of coverage<sup>4</sup> and most claim-handling obligations.*

*The debate surrounding this practice has focused on multiple subjects, such as whether the fronting practice is a way to circumvent state statutes,<sup>5</sup> whether the fronting practice is good or bad when analyzed from the perspective of the policyholder<sup>6</sup>, the regulators,<sup>7</sup> or the industry,<sup>8</sup> and*

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<sup>1</sup> See Thomas Holzheu, *Alternative Risk Transfer (ART) Products*, in *Reinsurance: Fundamentals and New Challenges* 113, 117 (Ruth Gastel ed., 4th ed. 2004).

<sup>2</sup> See *Reliance Ins. Co. v. Shriver, Inc.*, 224 F.3d 641 (7th Cir. 2000).

<sup>3</sup> See ROBERT H. JERRY, II & DOUGLAS R. RICHMOND, *UNDERSTANDING INSURANCE LAW* 1017 (4th ed. 2007).

<sup>4</sup> See ERNEST H. GORE, *PROPERTY/CASUALTY INSURANCE: A BASIC GUIDE* 160 (2008).

<sup>5</sup> See, e.g., Salvatore R. Curiale, *The Dark Side of Fronting*, *RISK MANAGEMENT*, Jan. 1991, at 26-27.

<sup>6</sup> See, e.g., Fred A. Simpson, *When Fronting Carriers Fail, Equity Protects Policyholders*, 8 J. TEX. INS. L. 2 (2006).

*also whether the practice should be banned or further regulated. As will be examined in this article, some regulatory attempts relating to the fronting practice have been discussed by the National Association of Insurance Commissioners (NAIC),<sup>9</sup> while certain jurisdictions have gone beyond the attempt and have actually enacted statutory provisions on this matter. In addition, there is case law examining this practice and recent rulings are worthy of thought.*

*Given the above considerations, this article seeks to provide a thorough analysis of this practice, the motivations for companies to support it, as well as its negative aspects and associated risks. This article will also examine regulatory reactions, statutes, and recent case law dealing with the subject of fronting.*

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## I. INTRODUCTION TO FRONTING ARRANGEMENTS

### A. DIVERSITY OF DEFINITIONS

As noted above, the practice of fronting involves an insurance company that issues a policy, which is then completely reinsured with a reinsurance carrier. This reinsurance carrier is usually unlicensed in the jurisdiction of interest. Notwithstanding some approaches to reach a definition of fronting and although most regulators would agree that fronting includes a cession of an entire line or class of insurance to an unlicensed carrier who controls the underwriting and claims decisions, there is no common definition among the states or within the industry.<sup>10</sup> Moreover, one could validly argue that this practice has the characteristics of a “chameleon”, because fronting may take different forms and appearances depending on the specific motivation for its use.

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<sup>7</sup> See, e.g., NEW YORK INS. DEP’T, FRONTING QUESTION PRESENTED: LEGAL OPINION, (Jan. 14, 2005), <http://www.ins.state.ny.us/ogco2005/rg050111.htm>.

<sup>8</sup> See, e.g., Howard W. Greene & Jon Harkavy, *Fronting is a Consumer Right*, RISK MANAGEMENT, Jan. 1991.

<sup>9</sup> See Vincent J. Vitkowsky & John L. Ingersoll, *Survey of 1992 Developments in the Public Regulation of Insurance*, 28 TORT & INS. L.J. 408, 408 (1993).

<sup>10</sup> See NAC Reinsurance Corp., Reinsurance Contracts: Content and Regulation 33 (1991) (unpublished material, available from NAC Reinsurance Corp., One Greenwich Plaza, Greenwich, CT 06836).

For example, fronting arrangements can be used to insure risks that a company cannot write directly.<sup>11</sup> When fronting is used to write business directly in a state where a given insurer is not licensed, it has been described by a Court as an arrangement through which a state-licensed insurance company issues certain policies, which are immediately reinsured to 100 percent of their face value by an out-of-state unlicensed insurer.<sup>12</sup> Such Court explained:

In a fronting arrangement - a well-established and perfectly legal scheme - policies are issued by a state-licensed insurance company and then immediately reinsured to 100 percent of their face value by the out-of-state, unlicensed insurer. In a typical fronting arrangement, the fronting insurer issues policies on its own paper and in its own name, and the out-of-state unlicensed insurer takes over the administration of all claims as part of the reinsurance agreement<sup>13</sup>.

When a fronting arrangement is used for self-insurance purposes, a Court described the fronting policy as "a form of self-insurance in which the deductible is identical to the limits of liability, and the insurance company acts only as surety that the holder of the fronting policy will be able to pay any judgment covered by the policy."<sup>14</sup> On a more aggressive court approach, it has been said that "[i]n a fronting policy, the insured essentially rents an insurance company's licensing and filing capabilities, but the insurance company does not actually pay any claims."<sup>15</sup> In this sense, by using fronting as a self-insurance mechanism, an insured can retain all of the risks originally covered by the fronting policy.<sup>16</sup>

Focusing on self-insurance and the captive<sup>17</sup> market, it has been said that fronting denotes a practice whereby "a commercial insurance

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<sup>11</sup> JERRY & RICHMOND, *supra* note 3.

<sup>12</sup> Reliance Ins. Co. v. Shriver, Inc., 224 F.3d 641, 643 (7th Cir. 2000).

<sup>13</sup> *Id.*

<sup>14</sup> Landers v. Lucent Technologies, Inc., Nos. 81506, 81531, 2003 WL 21468908, at \*2 (Ohio Ct. App. June 26, 2003).

<sup>15</sup> Dorsey v. Fed. Ins. Co., 798 N.E.2d 47, 51 (Ohio Ct. App. 2003).

<sup>16</sup> Tharp v. Berdanier, No. CIV.A. 21473, 2003 WL 22900646, at \*4 n.3 (Ohio Ct. App. Dec. 10, 2003).

<sup>17</sup> A captive insurance company can be defined as a "company formed to insure the risks of its parent corporation." HARVEY W. RUBIN, DICTIONARY OF INSURANCE TERMS 70 (5th ed, 2008).

company ("fronting company") licensed in the state where a risk to be insured is located, issues its policy to the insured," and such risk is then fully transferred to a captive insurance company.<sup>18</sup> Consequently, the insured obtains a policy issued on the paper of the commercial insurance company, but, economically, the risk of that coverage resides with the captive insurance company.<sup>19</sup>

Some authors conceptualize fronting as a specialized form of reinsurance.<sup>20</sup> While by examining common definitions of reinsurance,<sup>21</sup> the motivations for its use,<sup>22</sup> and its usual purposes<sup>23</sup> one could think of valid arguments against such conceptualization, it is difficult to differentiate between fronting and traditional reinsurance practices.<sup>24</sup> Even

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<sup>18</sup> See John Prescott & Deborah Lambert, *What's Up Front: A Guide to Fronting Arrangements*, Mar. 1 2002, <http://www.captive.com/newsstand/jlcovt/Fronting.html>.

<sup>19</sup> *Id.*

<sup>20</sup> Holzheu, *supra* note 1, at 116 n.2. See also Prescott & Lambert, *supra* note 18.

<sup>21</sup> Reinsurance is normally defined as "insurance for insurance companies." JERRY & RICHMOND, *supra* note 3. It can be defined as "the transaction whereby the assuming insurer in consideration of premium paid, agrees to indemnify the ceding company against all or part of the loss which the latter may sustain under the policy or policies which it has issued." See REINSURANCE ASS'N OF AMERICA, FUNDAMENTALS OF PROPERTY AND CASUALTY REINSURANCE 47 (2008).

<sup>22</sup> It is argued that the "fundamental objective of insurance, to spread the risk so that no single entity finds itself saddled with a financial burden beyond its ability to pay, is enhanced by reinsurance". NAC Reinsurance Corp., *supra* note 10, at 1. In the same sense, "[r]einsurance is a mechanism used by the insurance industry to spread the risks it assumes from policyholders. Through it, the industry's losses are absorbed and distributed among a group of companies so that no single company is overburdened with the financial responsibility of offering coverage to its policyholders." Donald A. McIsaac & David F. Babbel, *The World Bank Primer on Reinsurance* 1 (World Bank Fin. Sector Dev. Dep't, Working Paper No. 1512, 1995).

<sup>23</sup> Normal motivations for reinsurance reside in the fact that reinsurance can increase an insurer's underwriting capacity, stabilize its profits from fluctuations, reduce unearned premium reserves, and provide protection against catastrophic losses. See GEORGE E. REJDA, PRINCIPLES OF RISK MANAGEMENT AND INSURANCE 116 (10th ed. 2008). From an economic perspective, one of the most important functions of reinsurance is the insurer's ability to take balance sheet credit for the amount of reinsurance coverage protection it holds. Deirdre G. Johnson, *Unlocking the Mysteries of Reinsurance*, 760 PRACTISING L. INST. 243, 255 (2007).

<sup>24</sup> See Greene & Harkavy, *supra* note 8.

though customary reinsurance definitions normally recognize the possibility that an insurer could potentially transfer “all” of the risk under a given policy,<sup>25</sup> one could argue that the fronting practice in principle does not seem to fit with the objectives, types, and purposes of reinsurance as to qualify as a specialized form of reinsurance. For example, fronting does not seem to pursue spreading risks within a given mass but actually involves the full transfer of a set risks to a reinsurer, who seems to act more like an insurer and less like a reinsurer. Moreover, fronting normally involves the transfer of claim handling obligations, which in traditional reinsurance are normally held by the underlying insurer.<sup>26</sup>

As noted above, one of the uses of fronting arrangements is to permit a reinsurer to write coverage that it cannot do directly.<sup>27</sup> Therefore, in this author’s opinion and for the purposes of this article, fronting will be considered as an arrangement that uses reinsurance as its transfer vehicle<sup>28</sup> and, therefore, as one of its components, but not necessarily constituting by itself a specialized form of reinsurance.

Aside from the situation described above, there is another practice that has been conceptualized as fronting reinsurance. “[F]ronting arrangements devised by direct insurers and reinsurers have been replicated by reinsurers and retrocessionaires” in the higher layers of coverage.<sup>29</sup> Unlicensed or unaccredited reinsurers may turn to other reinsurers to serve as fronts for reinsurance contracts in order to meet solvency, security or other statutory requirements,<sup>30</sup> thereby enabling the underlying insurer to obtain credit for the reinsurance coverage. When agreement is reached, the fronting reinsurer will issue the required reinsurance and will retrocede all or a significant portion of the risk to the unlicensed or unaccredited

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<sup>25</sup> See, e.g., JERRY & RICHMOND, *supra* note 3; REINSURANCE ASS’N OF AMERICA, *supra* note 21.

<sup>26</sup> See Aviva Abramovsky, *Reinsurance: The Silent Regulator?*, 15 Conn. Ins. L.J. 345, 372 (2009).

<sup>27</sup> JERRY & RICHMOND, *supra* note 3.

<sup>28</sup> In this sense, fronting has been defined as “arrangements by which an insurer, for a specified fee or premium, issues its policies to cover certain risks underwritten or otherwise managed by another insurer or reinsurer. The insurer *then transfers* all, or substantially all, of the liabilities thereunder to such insurers *by means of* reinsurance”. REINSURANCE ASS’N OF AMERICA, *supra* note 21, at 31 (emphasis added).

<sup>29</sup> BARRY R. OSTRAGER & MARY KAY VYSKOCIL, *MODERN REINSURANCE LAW AND PRACTICE* 1-25 (2d ed. 2000).

<sup>30</sup> *Id.*



carrier.<sup>31</sup> Fronting practices at these layers of coverage can enable an unlicensed or unaccredited alien reinsurer to effectively provide coverage without having to comply with the trust fund requirements that are customary for unlicensed alien reinsurers. This situation was explained by a federal court in New York when analyzing a case where a carrier acted as a front for a reinsurance syndicate from London.<sup>32</sup> The court explained:

Plaintiff ASRIC is an insurance company organized under Delaware law . . . Elkhorn/Delta was a member of a reinsurance syndicate in London managed by Stetzel Thomson & Co. Ltd. . . . Elkhorn/Delta was one of twenty-two members of this syndicate and the only member incorporated in the United States . . . According to ASRIC, because Elkhorn/Delta was the only member incorporated in the United States, Stetzel designated Elkhorn/Delta as the “fronting” company for the syndicate . . . Under the law of Delaware, ASRIC's state of incorporation, an insurer will receive reinsurance credit only if the reinsurer is licensed to transact insurance in Delaware or in another state with comparable standards of insolvency for insurance companies. If the reinsurer is an unincorporated alien insurer, the reinsured can obtain reinsurance credit only if the reinsurer establishes a trust fund here for the benefit of the reinsured.” Because most states have comparable standards, the fronting arrangement allowed ASRIC to obtain a reinsurance credit for all the risks ceded to Elkhorn/Delta, without the other members of the syndicate having to post security in the United States.<sup>33</sup>

Considering the various uses and forms of fronting, the development of a precise definition is not a simple task. Moreover, the definition that a given jurisdiction may adopt would probably depend on the specific concerns that such jurisdiction may find in the practice of fronting. Nevertheless, by examining the common elements of its various uses, the author of this article considers that a definition of fronting could be proposed as follows:

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<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> *American Special Risk Ins. Co. v. Delta America Re Ins. Co.*, 836 F. Supp. 183, 184-85 (S.D.N.Y., 1993).

Fronting describes a series of alternative risk-transfer methods that share the following common elements: a) the presence of a company (fronting company) that issues an insurance or reinsurance policy, which is then completely or substantially ceded to a carrier (assuming carrier), b) the assuming carrier is normally unlicensed or unaccredited in the jurisdiction where the fronting company is licensed or accredited, c) the assuming carrier normally controls the underwriting and claims decisions of the respective policy or policies.

B. PURPOSES AND MOTIVATIONS.

Considering the variety of definitions and uses of fronting arrangements, it is reasonable to infer that these risk-transfer schemes can respond to various purposes and motivations, which depend on the specific business of a given company or group of companies. In general terms, it can be said that fronting arrangements may respond to one or more of the following motivations:

\* *For Licensing Purposes*: By means of a fronting arrangement, a carrier is enabled to write coverage that it cannot do directly<sup>34</sup> by using the services of a fronting company that is licensed in the state of interest. Such a risk-transfer method may be used where the insurer is not licensed to write business or a specific line of insurance in a particular state, and where the specific - and sometimes multi-state - insurance program would require such licensure<sup>35</sup>.

A fronting program may permit an insurer to write national programs during the time its' state licenses are being processed.<sup>36</sup> It may also be an appropriate tool when "statutory prohibitions serve to undercut an insurer's longstanding relationship with its insured."<sup>37</sup> Needless to say, this licensing motivation is normally subject to strong criticism by state

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<sup>34</sup> JERRY & RICHMOND, *supra* note 3.

<sup>35</sup> See Larry P. Schiffer, *Up-Front About Reinsurance*, INT'L RISK MGMT. INST. (Jan. 2004), <http://www.irmi.com/expert/articles/2004/schiffer01.aspx>.

<sup>36</sup> See Robert M. Hall, *Fronting: Business Considerations, Regulatory Concerns, Legislative Reactions and Related Case Law* (2001), <http://www.robertmhall.com/articles/frontingdoc.htm>.

<sup>37</sup> Curiale, *supra* note 5.

regulators,<sup>38</sup> who see this as a way to circumvent state statutes, as will be noted in Section III of this article.

\* *For Rating Reasons*: Sometimes an insurance program or an insured will require a certain financial rating for a carrier to be qualified.<sup>39</sup> When this situation occurs and the interested carrier does not fulfill the rating requirement or later suffers a downgrade of its rating that could force it to exit the program, the interested carrier may use the services of a fronting company in order to comply with such rating requirements.<sup>40</sup>

\* *For the Purpose of Entering or Exiting a Given Market*: Fronting can be the mechanism through which a carrier may gradually enter a new insurance field with the financial and technical support of a reinsurer.<sup>41</sup> By using a fronting arrangement, a carrier may gradually test an insurance line or a whole market with additional security and protection. Conversely, fronting can also be a sound tool where a carrier wishes to exit a given field but regulatory requirements oblige the business to be renewed for a certain period of time.<sup>42</sup> The carrier will continue to renew the business during the required time period but completely transfer its risks to a given reinsurer.

As it will also be noted in Section III below, there is a significant caveat on this motivation, which is that despite the transfer of risk, the company may have not entirely freed itself from its liability and related obligations.<sup>43</sup>

\* *For the Functioning of Captive Companies*: There are situations in which a company or a group of companies consider that the creation of a “captive” insurance company, which they own and control, provides a method of obtaining insurance coverage for their operations in a more

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<sup>38</sup> For example, as addressed by the Committee on Insurance of the Association of the Bar of the City of New York in 1993, “[t]o insurance regulators, the term fronting usually has a pejorative connotation, implying a situation in which the reinsurance arrangement is a matter of form between a licensed ceding company and an unlicensed reinsurer, the purpose of which is to allow the unlicensed reinsurer to do indirectly what the state prohibits it from doing directly: sell insurance within the state. Regulators view fronting as a device which enables an unlicensed reinsurer to avoid the restrictions to which it would be subject if it were a licensed insurer directly issuing insurance policies to the public . . . .” OSTRAGER & VYSKOCIL, *supra* note 29, at 1-37.

<sup>39</sup> See Schiffer, *supra* note 35.

<sup>40</sup> *Id.*

<sup>41</sup> Hall, *supra* note 36.

<sup>42</sup> *Id.*

<sup>43</sup> See Abramovsky, *supra* note 26, at 372.

efficient and productive manner.<sup>44</sup> Captives can be defined as special purpose insurance companies which are created for insuring or reinsuring the risks of its parent company or associated corporation.<sup>45</sup> In this type of ART method, fronting is said to be a necessary service for the success of captive insurers.<sup>46</sup>

Because captives are normally off-shore or out-of-state companies<sup>47</sup> that would probably not comply with statutory requirements for insurers, a majority of captives lack the required licenses to transact business of insurance.<sup>48</sup> The captive operation, therefore, normally requires the existence of a fronting arrangement to enable the risk-transfer mechanism.<sup>49</sup> Because of the size<sup>50</sup> and popularity<sup>51</sup> of the captive business, one would think that the majority of fronting arrangements probably occur within the captive market arena.

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<sup>44</sup> See JERRY & RICHMOND, *supra* note 3.

<sup>45</sup> Thomas F.X. Hodson & Cathleen T. Heath, *The Outlook for Fronting (Special Report: Captives & ART)*, RISK & INSURANCE (Mar. 1, 2002).

<sup>46</sup> *Id.*

<sup>47</sup> The primary jurisdictions where captives are incorporated are Bermuda, the Cayman Islands, and the state of Vermont. See TOWERS PERRIN, CAPTIVES 101: MANAGING COST AND RISK 1, <http://www.captive.com/service/TowersPerrin/images%20and%20pdf/Captives%20101.pdf>.

<sup>48</sup> Hodson & Heath, *supra* note 45 (“Generally, a company must be licensed to do business in the jurisdiction in which a policy is issued. A majority of captives lack the required licenses to do business and, therefore, captives often must use a fronting arrangement in order to do business in a state in which its parent's risks are located. A fronting insurer is a licensed carrier that issues the policies that a captive cannot issue.”).

<sup>49</sup> See *id.* (“A typical fronting arrangement will operate as follows: (i) the captive's parent pays a premium to the fronting insurer; (ii) the fronting insurer issues a policy to the parent; (iii) the fronting insurer cedes the balance of the remaining premiums back to the captive; and (iv) the captive may retrocede a portion of the risk to a reinsurer.”).

<sup>50</sup> See TOWERS PERRIN, *supra* note 47 (“Captive insurance is big business. More than 40% of major U.S. corporations and many multinational companies own one or more captives.”).

<sup>51</sup> As a curious note, even the teams of the National Football League (NFL) created in 1984 a Bermuda captive for the purposes of reinsuring the teams' workers' compensation insurance through fronting arrangements, although such company ended in liquidation proceedings. See *N.F.L. Ins. Ltd. v. B & B Holdings, Inc.*, No. 91 CIV. 8580, 1993 WL 78090 (S.D.N.Y. Mar. 18, 1993).

It has been noted that the use of captives and fronting arrangements normally increase in times of hard market conditions.<sup>52</sup> The hardening of the market creates a series of challenges for companies such as increased cost of risk management programs, decreased coverage, changes in terms and conditions of coverage, reduced limits or capacity offered at renewal, and increased deductibles and retentions mandated by carriers.<sup>53</sup> This market situation normally causes a significant number of companies to seek alternative risk-transfer schemes, such as the use of captives and fronting arrangements. As noted in recent industry surveys, fronting is an essential service for the captive industry.<sup>54</sup>

\* *For Tax Deduction Purposes:* Although this motivation is normally linked with the operation of captive insurers, it is appropriate to treat it separately due to its importance. Normally, a company that chooses to insure its operations through a captive company would wish to achieve tax deductibility of its premiums through successful risk-shifting.<sup>55</sup> The reasons are obvious; while premiums paid to a captive insurance company are deductible as business expense for tax purposes, the sums set aside in a self insurance program are not deductible as a business expense.<sup>56</sup>

It is important to point out that on December 11, 2009 the Internal Revenue Service (IRS) released two Private Letter Rulings, where it approved the use of a captive reinsurance arrangement involving a fronting insurer.<sup>57</sup> In these rulings, the IRS analyzed the situation where a group of

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<sup>52</sup> See Hodson & Heath, *supra* note 45.

<sup>53</sup> *Id.*

<sup>54</sup> The 2010 results of the annual survey conducted by the Captive Insurance Companies Association (CICA), show that 100% of consulted captive entities rated the overall level of importance of fronting to their captive as either very important or important. Other aspects of interest follow: a) 78% of respondents said that having an A rated fronting company as very important, b) 85% of respondents listed admitted paper among the primary reasons for using a front, c) 46% of respondent listed regulatory compliance among the primary reasons for using a front, and d) 89% of respondents characterized the price of fronting as reasonable. See *United States: 2010 Survey Results on Fronting and Reinsurance Released by CICA*, PRWEB (March 11, 2010), <http://www.prweb.com/pdfdownload/3689674.pdf>.

<sup>55</sup> See Prescott & Lambert, *supra* note 18, at 1.

<sup>56</sup> See RUBIN, *supra* note 17, at 70.

<sup>57</sup> See *IRS Approves Captive Reinsurance Arrangement as "Insurance" for Tax Purposes*, SONNENSCHN CLIENT ALERT (Feb. 4, 2010), [http://www.snrrenton.com/news\\_\\_insights/alerts/irs\\_approves\\_captive\\_reinsuran.a.spx](http://www.snrrenton.com/news__insights/alerts/irs_approves_captive_reinsuran.a.spx).

individuals formed a captive reinsurer, which ultimately reinsured certain risks originally insured by a fronting company.<sup>58</sup> The IRS considered that the captive reinsurance arrangements constituted insurance for tax purposes, since risk shifting and risk distribution were present in such arrangements.<sup>59</sup>

## II. ARGUMENTS IN FAVOR OF FRONTING ARRANGEMENTS

Despite the criticism and regulatory concerns towards fronting arrangements, it is unquestionable that such arrangements continue to exist today and with few exceptions remain unregulated. One could then validly think that these arrangements are not only widely used, as noted above in relation to the captive market, but must also have positive opinions and supporters.

In general terms, fronting arrangements have been considered as valid and legal mechanisms of risk-transfer by both courts and some industry experts.<sup>60</sup> The *Reliance* Court for instance described fronting arrangements as well-established and perfectly legal schemes.<sup>61</sup> Similarly, a footnote in the *Tharp* Court decision described fronting programs as legal

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<sup>58</sup> *Id.* “In the facts of each PLR, a group of individuals formed a domestic captive reinsurer (the Company) which ultimately reinsured certain risks of two groups of entities. One group of entities (the related entities) was owned by the shareholders of the Company; the other group of entities (the unrelated entities) was unrelated to the Company. The risks of each entity were insured by a fronting insurer; portions of the insured risk were reinsured by two intermediate reinsurers before being ultimately reinsured by the Company.”

<sup>59</sup> *Id.* “The PLRs held that the Company’s captive reinsurance arrangement constituted insurance for tax purposes, applying the definition of insurance enunciated in the seminal 1941 Supreme Court case of *Helferich v. LeGierse*, 312 U.S. 531 (1941). The Court stated in *LeGierse* that, in order for an arrangement to constitute insurance for tax purposes, risk shifting and risk distribution must be present. . . . A private letter ruling such as the PLRs constitutes binding authority only for the taxpayer to whom it is issued. Nonetheless, such a ruling is viewed as expressing the current views of the IRS with respect to the subject matter of the ruling.”

<sup>60</sup> *See, e.g., Simpson, supra* note 6, at 1 (“Through variations of these arrangements, companies enjoy a lawful and cost effective way to self-insure losses without meeting the formal legal requirements to qualify as insurers (or self-insurers) in those jurisdictions where the companies do business.” *See also* JERRY & RICHMOND, *supra* note 3 (“Although ‘fronting’ has a pejorative connotation in most usages, fronting in insurance is often highly appropriate.”).

<sup>61</sup> *See Reliance Ins. Co. v. Shriver, Inc.*, 224 F.3d 641, 643 (7th Cir. 2000).

risk management devices.<sup>62</sup> Considering the potential levels of coverage where fronting may occur, it has been noted that both insurer-reinsurer and reinsurer-retrocessionaire fronting contracts have been upheld in the face of challenges to their validity.<sup>63</sup> It must be noted that even though fronting is a controversial subject, most commentators do not address whether it is legal or not, they simply note that it is an existing practice that causes significant concerns.<sup>64</sup>

Upon analyzing the question of whether New York Insurance Laws restricted or prohibited fronting, the New York Insurance Department concluded that proper licenses shall be obtained if an unauthorized insurer, under the guise of reinsurance, engaged in activities that would require a license.<sup>65</sup> Nonetheless, the Department acknowledged that the Insurance Laws do not preclude an unauthorized insurer from reinsuring 100% of an authorized insurer's risks, as long as this activity does not allow the unauthorized insurer to engage in activities that would otherwise require it to obtain a license.<sup>66</sup>

One of the most avid critics of fronting has even considered that the practice should not necessarily be banned and noted that some fronting is useful.<sup>67</sup> Other experts acknowledge some of the benefits that fronting may bring.<sup>68</sup> Some authors have even qualified fronting as a consumer

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<sup>62</sup> See *Tharp v. Berdanier*, No. CIV.A. 21473, 2003 WL 22900646, at \*4 n.3 (Ohio Ct. App. Dec. 10, 2003).

<sup>63</sup> See OSTRAGER AND VYSKOCIL, *supra* note 29, at 1-28.

<sup>64</sup> Robert M. Hall, *Fronting and Direct Actions Against Reinsurers: The Final Chapter*, 1 (2008), <http://www.robertmhall.com/articles/FrontFinalChapArt.pdf>. ("Experienced insurance executives know that fronting carries with it significant business, regulatory and solvency concerns. It has been on and off the regulators' radar screen for at least fifty years.")

<sup>65</sup> See NEW YORK INS. DEP'T, *supra* note 7.

<sup>66</sup> *Id.*

<sup>67</sup> See Curiale, *supra* note 5 ("Does this mean regulators should ban the practice? Not necessarily; some fronting is useful and arguably should remain. Fronting can, in limited and defined instances offer a means by which all parties can achieve their goals in a cost-effective manner. For example fronting may be appropriate when statutory prohibitions serve to undercut an insurer's longstanding relationship with its insured. This may occur when an insurer of a multistate firm lacks the requisite authority for writing particular lines in certain states or when an overseas insured opens a U.S. branch and seeks to retain its foreign-based insurer, especially when such insurer would qualify (and perhaps intends to apply) for licensure in the state in which the risks are resident.").

<sup>68</sup> See, e.g., Hall, *supra* note 36 ("From a business standpoint, fronting has two benefits: (1) it allows reinsurers to run primary insurance programs without being

right, and considered that its elimination would not only be bad policy but would be an anti-consumer policy.<sup>69</sup>

### III. NEGATIVE OPINIONS AND REGULATORY CONCERNS

As much as fronting may have supporters of the practice, it does have a considerable number of opponents, especially among regulators.<sup>70</sup> The most common argument cited against fronting is that it enables an unauthorized carrier to circumvent existing statutes<sup>71</sup> and offer direct coverage without proper licensing. On the contrary, at least two authors consider this argument as “ironic” since a major reason of fronting is to

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licensed as such or establishing the mechanisms to service insureds; and (2) its gives primary insurers the opportunity to profit from fronting fees without incurring significant insurance risk.”). But the author warns that “[w]hile the first benefit may be real, the second is often illusory given the highly leveraged nature of the transaction, the adverse interests inherent in the relationship and the particular vulnerability of the front when something goes wrong. Many insurers have learned through sad experience the pitfalls of fronting.” *Id.*

<sup>69</sup> See Greene & Harkavy, *supra* note 8 (“Problems with definition aside, eliminating fronting is bad policy because it is anti-consumer. Fronting is not done to the policyholder; it is done for the policyholder. When an admitted carrier enters a fronting arrangement with a policyholder's captive, it does so at the behest of, and for the benefit of, that policyholder.”).

<sup>70</sup> See Hodson & Heath, *supra* note 45 (“While fronting is accepted as a necessary service for the success of captive insurers, it is not necessarily favored from a regulatory standpoint.”). See also Schiffer, *supra* note 35 (“In certain states, fronting is not looked at very favorably by insurance regulators.”); Vitkowsky & Ingersoll, *supra* note 9, at 417 (“While fronting transactions serve useful functions, insurance regulators believe that fronting transactions should be subject to careful scrutiny. There is great discomfort among regulators with the notion of unlicensed foreign and alien insurers using a licensed insurer to reinsure risks in the licensed insurer's state of domicile, when such foreign and alien insurers are not subject to state regulation.”).

<sup>71</sup> See Curiale, *supra* note 5 (“No matter how you slice it, fronting is a fiction designed to circumvent the existing insurance regulatory framework.”). See also Greene & Harkavy, *supra* note 8 (“Opponents view fronting as a method of circumventing state laws.”); JERRY & RICHMOND, *supra* note 3 (“Also, at times such [fronting] policies may be written for illegal or unethical purposes, such as for the purpose of evading state regulation or taxation.”); Hodson & Heath, *supra* note 45 (“When a company fronts business and then reinsures it 100 percent to a captive, a regulatory may see the transaction as a way to circumvent the licensing requirements of the state.”).



seek compliance with state laws relating to financial responsibility.<sup>72</sup> Another weakness in the circumventing argument is that it could be used against any conduct a regulator dislikes. For instance, a tax regulator could use a similar argument against customary tax advice. Thus, it must be recognized that as the market evolves into new practices, it usually dictates ways to legally conduct certain businesses, which may initially seem to circumvent the statutes but in the end result to be perfectly legal schemes.<sup>73</sup>

Very similar or at least related to this circumventing argument, is the notion that fronting aids and abets an unlicensed carrier to do business within a given jurisdiction.<sup>74</sup> In an opinion issued by the New York Insurance Department, about one year after the opinion cited in Section II above, the Department clearly stated its position that through fronting, a licensed insurer may illegally aid an unlicensed carrier.<sup>75</sup> The opinion states the following:

The Department is also concerned about the issue of fronting, which generally arises when a ceding insurer is 100% or substantially insured on a risk, by an unauthorized insurer. This situation occurs when unauthorized insurers, in order to avoid New York's statutory requirements, enter into reinsurance agreements with domestic companies who, in essence, act as fronting companies for the unauthorized insurers. Any arrangement or activity that would constitute the aiding of an unauthorized insurer would violate Section 2117 of the Insurance Law, and any authorized insurer that did any business that is equivalent to one of the specified types of insurance contained in N.Y. Ins. Law § 1101(b)(1) (McKinney Supp. 2005) in a manner designed to evade the provisions of the Insurance Law would be in violation of N.Y. Ins. Law § 1102 (McKinney

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<sup>72</sup> See Greene & Harkavy, *supra* note 8.

<sup>73</sup> As expressed by Allan Meltzer in the Wall Street Journal, "[t]he first principle of regulation is: Lawyers and politicians write rules; and markets develop ways to circumvent these rules without violating them." See Abramovsky, *supra* note 26, at 345.

<sup>74</sup> See Hall, *supra* note 36.

<sup>75</sup> See NEW YORK INS. DEP'T, REINSURANCE – PERCENTAGE OF RISKS RETAINED BY CEDING INSURER: LEGAL OPINION, (Jan. 6, 2006), <http://www.ins.state.ny.us/ogco2006/rg060105.htm>.

Supp. 2005). Each case would be evaluated on its own facts.<sup>76</sup>

At least one author has considered the aiding and abetting argument as “metaphorical” because most states have very precise rules on what activities by unauthorized insurers constitute doing business and fronting generally does not violate such rules.<sup>77</sup> One could also argue that if regulators wish to ban or regulate fronting, a precise and clear rule should be the way to do so, instead of relying on potentially ambiguous or questionable arguments.

Regulators have also expressed concern about the potentially fraudulent conduct that may be committed through the use of fronting.<sup>78</sup> Some arrangements may trick consumers into believing they are doing business with a sound insurer when in reality their insurance is being provided by an unfunded or unknown carrier.<sup>79</sup> Without a doubt, fronting would serve a dark purpose under this scenario. One could think of fronting as an ethical practice when chosen or at least known by the insured, but it certainly turns unethical when used with the intent to deceive the policyholder.

Another commonly cited concern of fronting is the potential solvency issue that may arise from its practice, as it could threaten the solvency of the ceding insurer.<sup>80</sup> This concern involves situations such as credit risks associated with fronting practice, potential insolvency of the fronting company, and even potential insolvency of the reinsurance or captive company. On this matter, it should first be noted that even when a fronting company cedes all of the risk associated with a policy, that company still remains liable to the direct insured for all of the associated

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<sup>76</sup> *Id.*

<sup>77</sup> See Hall, *supra* note 36.

<sup>78</sup> See OSTRAGER & VYSKOCIL, *supra* note 29, at 1-39.

<sup>79</sup> *Id.*

<sup>80</sup> Greene & Harkavy, *supra* note 8 (“First, some contend that fronting threatens the solvency of the ceding insurer. They argue that the ceding insurer is putting itself on the hook for risks it does not underwrite, since it simply passes the risk on to a reinsurer for a fee.”). But the author validly points out that “[i]f a regulator questions the security of fronted business, he or she has the power to deny credit for reinsurance to the ceding carrier in accordance with state laws . . . . The power to grant or deny credit for reinsurance is available to regulators for traditional reinsurance arrangements, and fronted transactions should be treated just like any other.” *Id.*

coverage.<sup>81</sup> Consequently, if the reinsurer becomes insolvent or there is a substantial coverage disagreement,<sup>82</sup> the fronting carrier will find itself in a very difficult position, since it will face the obligation to pay 100% of the ceded risks with a very small percentage of the premium.<sup>83</sup> For these reasons, a prudent fronting carrier should investigate its reinsurer's reputation and claims-handling practices,<sup>84</sup> and obtain appropriate collateral security.<sup>85</sup> Such collateral is useful not only to protect the company from the credit risk associated with potential failure by the reinsurer, but also to address the balance sheet impact of an unlicensed reinsurer on the fronting company due to the application of statutory accounting principles.<sup>86</sup> Although these measures do not solve the problem entirely, as the operations still carry associated risks, they do help reducing some of these risks.

Another complicated situation may be present in the event of insolvency of the fronting carrier. Absent a cut-through endorsement<sup>87</sup> and due to the highly probable presence of a standard insolvency clause<sup>88</sup> in the reinsurance agreement, if the fronting company goes insolvent, the reinsurance recoverable would probably be collected for the benefit of all policyholders of the front and not necessarily for any specific underlying insured. This would certainly destroy the original intent of the fronting program and would leave the insureds with no protection. As will be

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<sup>81</sup> See OSTRAGER & VYSKOCIL, *supra* note 29, at 1-26.

<sup>82</sup> Klaus Gebhardt, *Being Clear Up Front: There are More Areas of Potential Reinsurance Coverage Disputes Than You May Think*, BEST'S REVIEW, May 1, 2002 ("Apart from the obvious credit risk associated with ceding business to other insurance and reinsurance companies, the peril of fronting also may manifest itself in coverage disagreements.").

<sup>83</sup> See Hall, *supra* note 36.

<sup>84</sup> See OSTRAGER & VYSKOCIL, *supra* note 29, at 1-27.

<sup>85</sup> See William N. Curcio, *Putting up a Good Front*, BEST'S REVIEW, Oct. 2003, at 71, 74.

<sup>86</sup> *Id.*

<sup>87</sup> "A cut-through endorsement amends a reinsurance agreement by providing that, in the event of insurer insolvency, the reinsurer will pay reinsurance proceeds due to the insurer directly to the individual or entity named in the endorsement." See NAC REINSURANCE CORP., *supra* note 10, at 34.

<sup>88</sup> An insolvency clause will nearly be found in all reinsurance contracts due to statutory rules relating to credit for reinsurance, and will allow the liquidator of an insolvent insurer (normally the Commissioner of Insurance in a given state) to directly collect the reinsurance recoverable under reinsurance contracts for the benefit of all policyholders and creditors of the insolvent company. See NAC REINSURANCE CORP., *supra* note 10, at 29.

examined under Section V of this article, this situation could be solved if recent court rulings, that recognize a direct policyholder action against reinsurers of a fronting program, become adopted as standard case law for fronting practices.

#### IV. REGULATION OF FRONTING ARRANGEMENTS

Considering the regulatory concerns over the practice of fronting, there have been various proposals to regulate it which go back as far as the 1950's.<sup>89</sup> For example, in the 1970's and the 1980's, the New York Department of Insurance proposed a fronting regulation (Regulation 82) due to their ongoing concern about this practice, but the Regulation was never adopted.<sup>90</sup>

The National Association of Insurance Commissioners has also discussed proposals to regulate the practice, most notably the draft model acts entitled "Limitations on Reinsurance Activities of Insurers Model Act"<sup>91</sup> and the "Fronting Disclosure and Regulation Model Act".<sup>92</sup> These attempts, however, encountered severe opposition in the industry, due to the prevalence of using fronting arrangements for captives and other businesses.<sup>93</sup>

Despite such strong opposition from the industry, the NAIC adopted the "Fronting Disclosure and Regulation Model Act" in their

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<sup>89</sup> See Hall, *supra* note 36.

<sup>90</sup> See NEW YORK INS. DEP'T, *supra* note 7.

<sup>91</sup> Vitkowsky & Ingersoll, *supra* note 9, at 416.

<sup>92</sup> See Hall, *supra* note 36.

<sup>93</sup> See Vitkowsky & Ingersoll, *supra* note 9, at 417 ("An early 1992 exposure draft of the fronting model Act received a great deal of criticism from the insurance industry."). See also Greene & Harkavy, *supra* note 8, at 29 ("If the NAIC's draft model act were to become law, it would mean that policyholders would lose an important part of their ability to manage their own risks. No longer could captives be used to reinsure their parents' coverage. Risk managers would be unable to tap admitted reinsurance capacity and the excess and umbrella market. The NAIC draft would prohibit policyholders from using capacity for difficult-to-place risks which may not be available in the traditional market under acceptable terms. Risk managers would not even be permitted to designate the reinsurers on their own risks. In short, many responsible and well-established insurance programs would no longer exist.").

Winter National Meeting in December, 1993.<sup>94</sup> The purpose of the Act, as provided in its June 1993 Draft, is as follows:

The purpose of this Act is to ensure proper disclosure and regulation of reinsurance transactions in which an insurer domiciled in this state or, if the transaction covers risks resident in this state, an insurer licensed in this state, delegates to an unauthorized reinsurer underwriting or claim settlement authority, on business written directly by the licensed insurer or assumed from another licensed insurer.<sup>95</sup>

The Act later provides the requirement of prior regulatory approval for certain reinsurance transactions, most notably: a) when the annual gross written premium for business subject to the proposed transaction exceeds 5% of the insurer's statutory policyholder surplus, as reported in its most recent financial statement,<sup>96</sup> b) when annual gross written premium for the business subject to the transaction when added to all similar transactions is expected to exceed 15% of the insurer's statutory policyholder surplus, as reported in its most recent financial statement.<sup>97</sup>

Despite certain exemptions contemplated in the Act, the industry's opposition continued to be strong.<sup>98</sup> A sector of the industry considered the NAIC regulation not only as redundant but as impeding consumer access to alternative risk-transfer methods.<sup>99</sup> Moreover, it was alleged that the practical result of this regulation was to increase the costs of captive transactions because the additional burdens placed on the fronting carriers would be passed on to the captives.<sup>100</sup> It appears that the opposition was strong enough since the Model Act was not adopted by any state.<sup>101</sup>

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<sup>94</sup> See NAT'L ASS'N OF INS. COMM'RS, FOURTH QUARTER 1993 PROCEEDINGS 15 (Mar. 1995).

<sup>95</sup> See NAT'L ASS'N OF INS. COMM'RS, Third Quarter 1993 Proceedings, 665 (Nov. 1994).

<sup>96</sup> *Id.* at 666.

<sup>97</sup> *Id.* at 667.

<sup>98</sup> See Paul S. Brown, *Insurance Consumer Wary of Insurance Regulators*, ROUGH NOTES (Jan. 1, 1994), available at [http://findarticles.com/p/articles/mi\\_qa3615/is\\_199401/ai\\_n8726254](http://findarticles.com/p/articles/mi_qa3615/is_199401/ai_n8726254).

<sup>99</sup> *Id.*

<sup>100</sup> *Id.*

<sup>101</sup> See Hall, *supra* note 36.

Despite the failure of the NAIC Model Act, certain states – most notably Florida<sup>102</sup> – have issued some form of regulation of fronting, either by statute, regulation, or bulletin. It has been noted,<sup>103</sup> however, that the number of states is very limited – only 17 states and the Virgin Islands – and that their regulation is either vague or overly broad.<sup>104</sup> Additionally and as previously mentioned, other states rely on the Aiding and Abetting statutes in an attempt to forbid the fronting practice.<sup>105</sup>

As noted above, fronting regulation has often failed to be precise or to even contain definitions of the forbidden practice. If regulators want proper regulation of fronting practices, a clear and precise language should be the norm. For example, such language could refer to the amount of risk retained by a fronting carrier<sup>106</sup> or the delegation of claims handling

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<sup>102</sup> Florida statutes forbid an authorized insurer to act as fronting company for an unauthorized insurer which is not an approved reinsurer. FLA. STAT. § 624.404(4)(b) (2004). The statute later defines fronting company as “an authorized insurer which by reinsurance or otherwise generally transfers more than 50 percent to one unauthorized insurer which does not meet the requirements of s. 624.610(3)(a), (b), or (c), or more than 75 percent to two or more unauthorized insurers which do not meet the requirements of s. 624.610(3)(a), (b), or (c), of the entire risk of loss on all of the insurance written by it in this state, or on one or more lines of insurance, on all of the business produced through one or more agents or agencies, or on all of the business from a designated geographical territory, without obtaining the prior approval of the office.”. *Id.*

<sup>103</sup> See Hall, *supra* note 36.

<sup>104</sup> See, e.g., MASS. GEN. LAWS ch. 175, § 193U (excludes fronting transaction from the definition of a medical malpractice insurer but fails to define fronting); VA. CODE ANN. § 38.2-2614 (2007) (also forbids fronting but fails to define it); V.I. CODE ANN. tit. 22, § 1695 (1993) (limits the scope of fronting regulation by defining a fronting company as “an insurer or ambulance service association which by reinsurance or otherwise, generally transfers to one or more unauthorized insurers or ambulance service associations, the risk of loss under ambulance service contracts written by it in the territory”); OKLA. STAT. tit. 36, § 6627 (also vaguely defines a fronting company as “an authorized insurer or licensed service warranty association which, by reinsurance or otherwise, generally transfers to one or more unauthorized insurers or unlicensed service warranty associations, the risk of loss under warranties written by the company in this state.”).

<sup>105</sup> See NEW YORK INS. DEP’T, *supra* note 75.

<sup>106</sup> See HODSON & HEATH, *supra* note 45. (“The distinction between a ‘proper’ reinsurance transaction and an ‘improper’ fronting arrangement is perhaps found in the amount of risk retained by the fronting company and the purpose of the transaction. A regulator might question the legitimacy of a fronting arrangement if the purpose is solely to avoid a state’s licensing requirements and the entire amount of the risk is passed along by the fronting company.”).

obligations. As explained above, however, strong industry opposition should be expected to any regulatory attempt to curtail fronting arrangements.

## V. COURT EXAMINATION OF FRONTING ARRANGEMENTS

Under typical reinsurance contracts and absent a specific cut-through endorsement, an underlying insurer does not have privity of contract with, or a right of direct action against, a reinsurer<sup>107</sup>, since the only contracting parties are the cedent and the reinsurer<sup>108</sup>. This situation also arises due to the indemnity nature of the reinsurance contract, which requires the cedent insurer to initially pay a claim in its entirety before demanding the reinsurance recoverable.<sup>109</sup> Moreover, when a cedent insurer becomes financially troubled and is subject to state insolvency laws, reinsurance recoverables are normally collected by the Insurance Commissioner, or the state official administering the insolvency, by enforcing the insolvency clauses that are commonly required by statutes in order for the cedent to obtain credit for reinsurance.<sup>110</sup>

Both of the situations mentioned above would typically cause an insured to fail in an attempt to sue a reinsurer directly. Some courts, however, are inclined to accept a direct claim from an insured to a reinsurer when the financially-troubled insurer merely acts as a fronting company rather than a true insurer<sup>111</sup>. In these cases, reinsurers have been held to the same standards as insurers when they act as insurers rather than reinsurers<sup>112</sup>.

For example, in 1959 the Supreme Court of Missouri, upon analyzing a typical fronting case, held in *O'Hare v. Pursell* that by taking over the complete risk, service of business, and other obligations, a reinsurer put itself in the position of a contracting party with the insureds.

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<sup>107</sup> See Johnson, *supra* note 23, at 250; see also *J.C. Penney Life Ins. Co. v. Transit Casualty Company in Receivership*, 299 S.W.3d 668, 673-74 (Mo. Ct. App. 2009) ("Ordinarily, the original insured has no interest in the reinsurance. Indeed, a reinsurance contract 'operates solely as between the reinsurer and the reinsured. It creates no privity between the original insured and the reinsurer.' ... The reinsurer is 'solely and exclusively' liable to the reinsured and has no contractual obligation or liability to the original insured.").

<sup>108</sup> See REINSURANCE ASSOCIATION OF AMERICA, *supra* note 21, at 9.

<sup>109</sup> *Id.*

<sup>110</sup> See, e.g., CONN. AGENCIES REGS. § 38a-88-10(a).

<sup>111</sup> See Johnson, *supra* note 23, at 250.

<sup>112</sup> See Hall, *supra* note 36, at 6.

The Court held that the law supplied the privity necessary for insureds to maintain a direct action against the reinsurer<sup>113</sup>. Similarly, in 1979, the Court of Appeals of Indiana held in *Foremost Life Insurance Company v. Department of Insurance* that consumers may proceed directly against reinsurers as third party beneficiaries where a reinsurer assumes responsibility directly to the policyholders<sup>114</sup>. The Court analyzed a reinsurance treaty where the reinsurer took 100% of the risks and assumed all administrative responsibilities of the policies.

In addition to these opinions, there are two fairly recent cases - both from Pennsylvania - that are very important to consider as part of any fronting analysis. A brief explanation of such cases follows:

A. *KOKEN V. LEGION*<sup>115</sup>

This case involved petitions for liquidation of Legion Insurance Company and of Villanova Insurance Company by the Pennsylvania Insurance Commissioner, M. Diane Koken. Both Villanova and Legion were rather sizeable fronting insurers that became insolvent despite significant funding efforts by their common parent company<sup>116</sup>. As part of the proceedings, several insureds who used Legion as part of their fronting programs, sought direct access to the respective reinsurance agreements in order to avoid the reinsurance proceeds from going to the insolvent estate for the benefit of all creditors, as advocated by the Commissioner.

These insureds were Pulte Homes, Inc., Psychiatrists Purchasing Group, Inc., American Airlines, Inc., and Rural/Metro Corporation. The court recognized that in the fronting programs of these insureds, the reinsurer not only bore 100% of the underlying risk but was directly chosen by the respective policyholders as part of their fronting programs.<sup>117</sup>

Despite strong opposition, the Court approved the Commissioner's petition to liquidate the companies, but, it also granted the petition of the insureds and gave them third-party beneficiary status with respect to the reinsurance agreements. In doing so, the court applied the *Guy*<sup>118</sup> test with

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<sup>113</sup> See *O'Hare v. Pursell*, 329 S.W.2d 614, 620 (Mo. 1959).

<sup>114</sup> See *Foremost Life Insurance Company v. Department of Insurance*, 395 N.E.2d 418 (Ind. App. 1979).

<sup>115</sup> See *Koken v. Legion Ins. Co.*, 831 A.2d 1196 (Pa. Commw. Ct. 2003).

<sup>116</sup> See *Simpson*, *supra* note 6, at 3.

<sup>117</sup> See *Koken*, 831 A.2d at 1241.

<sup>118</sup> *Id.* at 1237 ("In *Guy* [*Guy v. Liederbach*, 459 A.2d 744 (Pa. 1983)], our Supreme Court established a two-part test for determining third-party beneficiary status: (1) recognition of the beneficiary's right must be 'appropriate to effectuate



regard to the insureds' third-party beneficiary status, but clarified that direct access to reinsurance is a right to be established on a case-by-case basis. The court reasoned:

The Policyholder Intervenor all assert third-party beneficiary rights but on different factual grounds. The rights of Pulte, Rural/Metro and PPG stem from facultative reinsurance agreements specific to their individual risks; they were issued facultative certificates. American claims rights under a reinsurance agreement that is not strictly facultative, *i.e.*, a facultative obligatory treaty. On the other hand, the contract, or wording, between Legion and Syndicate 271 contains language that expresses American's right to cut-through Legion to collect reinsurance directly from Syndicate 271 [Footnote omitted]. In spite of the differences in their circumstances, all the Policyholder Intervenor can demonstrate third-party beneficiary status under the two-part *Guy* test.

First, it was the intention of the parties that the reinsurer assume all underwriting risk. Legion's only role was that of a fronting company, and the parties did not intend that Legion use the proceeds of the reinsurance for its general business purposes. Further, the reinsurance proceeds were used exclusively and entirely for the payment of Policyholder Intervenor claims, which satisfies the second part of the *Guy* test. Payment by the reinsurance companies was through Legion but for the benefit of the Policyholder Intervenor. In short, each "reinsurer" functioned as the direct insurer for each of the Policyholder Intervenor.<sup>119</sup>

Direct access to the reinsurance contracts was granted in these situations because the "true" insurer of the policyholders was actually the

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the intention of the parties,' and (2) contract performance must 'satisfy an obligation of the promisee to pay money to the beneficiary' or 'the circumstances indicate that the promisee intends to give the beneficiary the benefit of the promised performance.'").

<sup>119</sup> *Id.* at 1237.

reinsurer and not Legion. As clarified by the court, granting such a right must be analyzed on a case-by-case basis.<sup>120</sup>

B. *ARIO V. SWISS RE.*<sup>121</sup>

This case involved the parties' objections to a Referee's ruling on whether direct access to reinsurance should be allowed on fronting programs covering the insured's liability for workers compensation upon insolvency of the fronting carrier. Both parties, the Insurance Commissioner and the insured Tribune Company, considered the *Koken* case to be supportive of their positions. Tribune wanted direct access to certain reinsurance recoverables under fronting programs, but the Insurance Commissioner considered that Tribune had no such right, relying on the reasoning of the *Koken* case<sup>122</sup>.

According to the facts of the case, Tribune Company and Swiss Reinsurance entered into certain fronting programs for Tribune's workers' compensation exposure, using Reliance Insurance Company as a front. The first program, entitled Guaranteed Cost Program (GCP), provided that Reliance would insure and transfer certain workers' compensation liabilities to Swiss Reinsurance, subject to certain interim and aggregate limits. This meant that Reliance was left with potential excess liability. The second program, entitled Loss Portfolio Transfer (LPT), provided that Reliance would also insure and transfer certain workers' compensation liabilities to Swiss Reinsurance. However, this program differed due to the absence of significant caps and the presence of excess insurance by Tribune. As a result, Reliance was left with no real exposure and acting merely as a pass-through entity.

Because the transaction was not structured as an up-front arrangement and Reliance retained certain underwriting risk, the court upheld the Referee's ruling that Tribune should not have direct access to reinsurance related to the GCP program<sup>123</sup>. As for the LPT program, the court also upheld the Referee's ruling that Tribune should have direct access to reinsurance since the purpose of the transaction was simply a pass-through liability to Swiss Reinsurance.<sup>124</sup>

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<sup>120</sup> *Id.* at 1236.

<sup>121</sup> *Ario v. Swiss Reins Am. Corp.*, 940 A.2d 552 (Pa.Comm. Ct. 2007).

<sup>122</sup> *See id.* at 554.

<sup>123</sup> *Id.* at 556.

<sup>124</sup> *Id.* at 558.

The court identified several factors to be used in deciding whether an insurer should have direct access to reinsurance. The factors to be considered are: 1) did the insurer take on any underwriting risk or act as a front, 2) did the insurer enter into the transaction in order to generate fees, and not premium, 3) did the 'reinsurer' function as a 'direct insurer' for the policyholder and was the claims handling process and the funding of claims the responsibility of the reinsurer, 4) did the policyholder facilitate the reinsurer's involvement, 5) did the equities favor the policyholder's claim to direct access.<sup>125</sup> Although this test could provide a useful guide for fronting situations, the court did not clarify if all factors had to be satisfied or if the presence of some but not all factors would suffice.

By examining the previously cited cases and opinions, one could conclude that courts are recognizing direct policyholder actions against reinsurers when there is a clear fronting program. But until such rulings are adopted by the overwhelming majority of courts, it is reasonable to think that each case will be evaluated on its own facts and such evaluations will vary considerably depending on the jurisdiction.

## VI. CONCLUSION

By analyzing the above considerations and facts, several conclusions can be reached. First, fronting can be characterized as a legal risk-transfer mechanism, except where it is expressly prohibited or restricted. Although there has been an ongoing discussion on whether or not the practice of fronting circumvents existing statutes, there does not seem to be a strong argument against it and courts have generally considered these arrangements as legal. If a given state wants to forbid or regulate the practice, then a clear and precise set of express rules should be the norm.

Second, fronting is a helpful tool when properly used as it may enable a company to plan a successful captive program or an insurer to maintain its long-standing relationship with a client. As noted above, fronting has been considered an essential component for the survival of the captive industry and even its most avid critics believe that at least some form of fronting should be allowed.

Third, even though reinsurance contracts normally do not grant any privity rights to the underlying policyholders, it is unquestionable that courts have taken a more progressive approach when viewing the fronting practice and they have acknowledged the reality of the relationship

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<sup>125</sup> *Id.*

between the parties. Courts are moving towards recognizing policyholders' direct rights of action against reinsurers when the cedent insurer has only acted as a front and the reinsurer is acting as the true insurer.

Fourth, despite the above remarks, one cannot blind oneself from the negative implications and consequences that fronting can bring when used improperly. It is understandable why regulators are concerned with the practice of fronting. There have been abuses that resulted in insolvencies, potential fraud on policyholders, and evasion of state controls. In this sense, at least some regulation is necessary and helpful. For such regulation to be successful, however, a precise definition of the targeted practice is fundamental.<sup>126</sup> The construction of a definition should focus on the common elements of the practice in order to achieve that precision.

Given the diverse characteristics and widespread uses of fronting arrangements, one can conclude that state authorities have the option of regulating this practice through either a general or specific regulatory approach. A general approach would seek to regulate fronting as a general practice, either by prohibiting it or by limiting and regulating its use. Again, a precise definition is a mandatory component of such legislation. In contrast, a specific approach would seek to regulate the areas or fronting practices that cause specific concerns to a given regulator, without banning or restricting the practice in general. For example, a given regulator may not be concerned about all fronting practices, but may be alarmed by specific aspects or uses of it<sup>127</sup>. The determination of the potential aspects to be regulated, however, depends on the specific concerns of each jurisdiction.

As general conclusion, fronting is a valid, useful, and legal tool, except where expressly prohibited. Due to the negative consequences that fronting may also bring, at least some regulation establishing clear and precise guidelines would be appropriate; but, a general ban of the practice would not be convenient, especially for the captive industry. If a state chooses to regulate fronting, a specific regulatory approach would not only be more effective for compliance and enforcement purposes, but would probably be viewed more positively by the industry. Ultimately, this is a matter of state choice.

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<sup>126</sup> See HALL, *supra* note 36, at 3.

<sup>127</sup> For example, when fronting is used to deceive consumers.



**ANNUITY COEPTIS: IS THERE A WAY TO AVOID  
AMERICAN EQUITY INVESTMENT LIFE INSURANCE CO. v.  
SEC BECOMING A HERALD FOR THE SEC GAINING  
REGULATORY CONTROL OVER ALL SECURITIES-  
RELATED INSURANCE PRODUCTS?**

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*This note is a critique of the July 2009 D.C. Circuit case American Equity Investment Life Insurance Co. v. SEC, in which the court rejected a challenge to the Securities Exchange Commission's Rule 151A, which had subjected fixed index annuities to SEC regulation. The court held that the 1933 Securities Act's section 3(a)(8) exemption for insurance did not exempt fixed index annuities from SEC regulation. This note begins by exploring in considerable detail the case law on the insurance exemption contained in the 1933 Securities Act. The note then looks at the history of the rise of fixed index annuities, and examines the economic theory that underlies index investing, which is the investment strategy that gave birth to a demand for fixed index annuities. The note proceeds to look at contemporary case law applying the insurance exemption to decide whether fixed index annuities are exempt from SEC regulation under section 3(a)(8). The note then offers substantive analysis of why fixed index annuities should be exempt as insurance. The note argues that fixed index annuities transfer the risk of stock-picking from insured to insurer and that the beta risk vs. non-beta risk distinction from index investing theory is a suitable basis for regulating index annuities differently than variable annuities. The note argues that fixed index annuities pose challenges of solvency and contractual interpretation, which are the regulatory challenges of insurance, but do not pose disclosure challenges, which are the regulatory challenges that the SEC addresses. The note then argues that the D.C. Circuit completely misunderstood the economics of how fixed index annuities function. The note concludes by offering policy arguments on why it is best for the states and not the SEC to regulate fixed index annuities.*

**I. INTRODUCTION**

In the July 2009 D.C. Circuit case *American Equity Investment Life Insurance Co. v. SEC*, the District of Columbia Court of Appeals addressed

the question of whether fixed index annuities are insurance.<sup>1</sup> This question matters because annuity products which qualify as insurance are exempt from the requirements of the Securities Act of 1933 because of the insurance exemption in § 3(a)(8) of the Act, and are therefore not subject to regulation by the Securities Exchange Commission.<sup>2</sup> The SEC had earlier in 2009 released its new Rule 151A, which stated that fixed index annuities (for the most part) are not insurance under § 3(a)(8) and are therefore subject to SEC regulation.<sup>3</sup> The petitioners, who included American Equity Investment Life Insurance Company, the National Association of Insurance Commissioners, and as amici curiae Phillip Roy Financial Services LLC and Allianz Life Insurance Company of North America, brought suit and argued that the SEC's classification of fixed index annuities as securities and not as insurance was unreasonable.<sup>4</sup> The court in *American Equity* held for a variety of reasons that the SEC had been reasonable in determining that fixed index annuities were not insurance.<sup>5</sup> The court relied heavily upon precedent in the two most relevant United States Supreme Court cases addressing the insurance exemption, *SEC v. Variable Annuity Life Insurance Co. of America (VALIC)* and *SEC v. United Benefit Life Insurance Co. (United Benefit)*.<sup>6</sup>

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<sup>1</sup> *Am. Equity Inv. Life Ins. Co. v. SEC*, 572 F.3d 923, 925 (D.C. Cir. 2009), amended by 2010 U.S. App. LEXIS 14249 (D.C. Cir. July 12, 2010).

<sup>2</sup> Securities Act of 1933 § 3(a)(8), 15 U.S.C. § 77c(a)(8) (2006). The insurance exemption in the Securities Act of 1933 provides that the Act does not apply to "[a]ny insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia." *Id.*

<sup>3</sup> Indexed Annuities And Certain Other Insurance Contracts, 74 Fed. Reg. 3138 (Jan. 16, 2009) (to be codified at 17 C.F.R. Pts. 230 and 240). The SEC was responding to allegations that buyers of fixed index annuities had been victimized by various frauds necessitating heightened regulation, including the possibility that fixed index annuities might be marketed as investments and sold to buyers for whom the fixed index annuities are not suited. *See, e.g.*, Jonathan S. Coleman, *Equity Indexed Annuities: "Securities," or Exempt Insurance Products Under the Federal Securities Laws?*, 34 SEC. REG. L.J. 80 (2006).

<sup>4</sup> *Am. Equity Inv. Life Ins. Co.*, 572 F.3d at 924-25.

<sup>5</sup> *Id.* at 934.

<sup>6</sup> *Id.* at 926.

Because I believe that the D.C. Circuit both misinterpreted the relevant precedent and severely misunderstood the nature of the financial product in question, I argue in this note that the court reached the wrong result in *American Equity* in holding that the insurance exemption did not apply to fixed index annuities. In the process of this analysis I present a new conceptual framework for understanding insurance, risk, and securities, which courts will be able to use when examining other quasi-security annuity products in the future. I conclude by examining the policy implications of whether the SEC should have a broad regulatory net for catching every new and innovative financial product or whether the SEC's mandate should be more narrow and allow more control to the states; I argue that the latter choice is preferable.

I begin by explaining the precedent that is important to understanding the issues relating to fixed index annuities in Part II. I then explore the theory of index investing, the rise of fixed index annuities, and the SEC's efforts to regulate fixed index annuities in Part III.A. Then I present the contemporary cases that reached the question of whether fixed index annuities qualify for the insurance exemption in Part III.B. In Part IV.A, I present my conceptual framework for understanding insurance risk and show why a fixed index annuity is actually a form of insurance and is not a security. I conclude with policy arguments in Part IV.B.

## II. PRECEDENT DEFINING THE SCOPE OF THE INSURANCE EXEMPTION

### A. EARLY CASES DEFINING SECURITIES AND INSURANCE

One of the first Supreme Court cases to discuss the question of what is insurance is *Helvering v. Le Gierse*, a case that involved a decedent who had purchased a life insurance policy and an annuity simultaneously from the same insurer for similar amounts, such that each policy hedged or counterbalanced the other.<sup>7</sup> The decedent died and the beneficiary tried to claim the life insurance proceeds as tax-exempt under a tax exemption for life insurance.<sup>8</sup> The Court held that the life insurance policy did not qualify as insurance for purposes of the insurance exemption in the 1933 Act because the two contracts considered as a whole did not constitute "risk-

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<sup>7</sup> *Helvering v. Le Gierse*, 312 U.S. 531, 536 (1941). The Court was interpreting section 302 of the Revenue Act of 1926. *Id.* at 537.

<sup>8</sup> *Id.* at 537.



shifting and risk-distributing,” which is the essence of insurance.<sup>9</sup> The Court found that usually life insurance involves shifting the risk of death from those dependent upon the insured to a group of people (implicitly, everyone else who buys life insurance).<sup>10</sup>

*Helvering* is significant because the *United Benefit* Court cites *Helvering* for two propositions: (1) that a contract which is insured is not a contract of insurance and, (2) assuming investment risk does not create insurance. The case does stand for those propositions, but the Court in *Helvering* also looked at whether a financial product shifts and distributes economic risk to determine whether or not it is insurance, whereas the Court in *United Benefit* failed to do this kind of *Helvering* analysis; later I will argue that an analysis of fixed index annuities satisfies this risk-shifting test used in *Helvering*.

In *SEC v. C.M. Joiner Leasing Corp.*, the Supreme Court held that a contract to sell and develop land was a security even though it did not precisely match the enumerated list of products defined as securities in the 1933 Act because it matched one of the more general descriptions of securities in the Act.<sup>11</sup> This case is relevant because it held that “what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect” are all relevant in determining whether a product is a security.<sup>12</sup>

The Supreme Court in the landmark case *SEC v. W.J. Howey Co.* held that deals termed land sales combined with management contracts were actually products that sold shared profits in citrus farms in exchange for contributions of money and were therefore securities.<sup>13</sup> The Court held that whether the financial product was speculative, and whether the product was backed by an asset with intrinsic value, was irrelevant to whether it was a security. Rather, “[t]he test is whether the scheme involves an investment of money in a common enterprise with profits to come solely

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<sup>9</sup> *Id.* at 539-40.

<sup>10</sup> *Id.* at 540.

<sup>11</sup> *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943). The Court was interpreting section 2(a)(1) of the Securities Act of 1933. *Id.* at 350.

<sup>12</sup> *Id.* at 352-53.

<sup>13</sup> *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946). The Court was interpreting section 2(a)(1) of the Securities Act of 1933. *Id.* at 297.

from the efforts of others.”<sup>14</sup> Fixed index annuities would clearly fit within this definition of securities unless the insurance exemption applied.<sup>15</sup>

B. *VALIC*

1. The Majority Opinion

The United States Supreme Court first had the chance to directly address the question of whether security-related annuities qualify for the insurance exemption to the 1933 Securities Act in *SEC v. Variable Annuity Life Insurance Co. of America (VALIC)*.<sup>16</sup> In *VALIC*, the court was faced with a variable annuity product in which the insured paid premiums into an account which were invested in common stocks and other equities by the insurer and then received payments from the insurer based upon the return of the investments.<sup>17</sup> The variable annuity insurer claimed that the variable annuity was insurance exempt from SEC regulation.<sup>18</sup> The *VALIC* majority held that the variable annuity was a security and not insurance.<sup>19</sup> Its reasoning is summed up in a key quote from the case:

We realize that life insurance is an evolving institution. Common knowledge tells us that the forms have greatly changed even in a generation. And we would not undertake to freeze the concepts of ‘insurance’ or ‘annuity’ into the mold they fitted when these Federal Acts were passed. But we conclude that the concept of ‘insurance’ involves some investment risk-taking on the part of the company. The risk of mortality, assumed here, gives these variable annuities an aspect of insurance. Yet it is apparent, not real; superficial, not substantial. In hard reality the issuer of a variable annuity that has no element of a fixed return assumes no true risk in the insurance sense. It is no answer to say that the risk of declining returns in times of

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<sup>14</sup> *Id.* at 301.

<sup>15</sup> See Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2006).

<sup>16</sup> *SEC v. Variable Annuity Life Ins. Co. of Am. (VALIC)*, 359 U.S. 65 (1959).

<sup>17</sup> *Id.* at 69.

<sup>18</sup> *Id.* at 66-68.

<sup>19</sup> *Id.* at 71.

depression is the reciprocal of the fixed-dollar annuitant's risk of loss of purchasing power when prices are high and gain of purchasing power when they are low. We deal with a more conventional concept of risk-bearing when we speak of 'insurance.' For in common understanding 'insurance' involves a guarantee that at least some fraction of the benefits will be payable in fixed amounts. The companies that issue these annuities take the risk of failure. But they guarantee nothing to the annuitant except an interest in a portfolio of common stocks or other equities an interest that has a ceiling but no floor. There is no true underwriting of risks, the one earmark of insurance as it has commonly been conceived of in popular understanding and usage.<sup>20</sup>

Thus, the Court found variable annuities were securities, not insurance, because the insurer did not assume risk and did not pay out a fixed amount.<sup>21</sup> I will return to this quote later, but for now I point out two things. First, the Court claims that fixed payments are required in order to constitute insurance.<sup>22</sup> The Court can be read to say that fixed payments are necessary to be insurance as a per se rule, or it can be read to say that the insurer assuming risk and providing a reduction in risk for the insured are necessary to constitute insurance, since the reasoning the court offers is that fixed payments are necessary precisely because they offer the reduction of risk for the insured and an assumption of risk in the insurance sense for the insurer. I discuss what it means to assume risk in the sense of insurance below. Second, the Court says it does not freeze a definition of insurance. To summarize the overall theory of the case, the *VALIC* majority expresses a theoretical paradigm for understanding insurance according to which "insurance" is defined as a product in which the insurer—not the consumer—bears the investment risk.

## 2. Justice Brennan's Concurrence

Justice Brennan wrote a long and influential concurrence in *VALIC* in which he agreed that the variable annuity was not insurance, but on

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<sup>20</sup> *Id.* at 71-73 (citations omitted).

<sup>21</sup> *Id.*

<sup>22</sup> *VALIC*, 359 U.S. at 70-71.

slightly different grounds than the majority.<sup>23</sup> His analysis was based upon looking at the purpose of the insurance exemption. In his view, the purpose of the insurance exemption was not that Congress wanted to prevent dual state-Federal regulation, nor that Congress believed that state insurance regulators who regulated insurance at the time the Act was drafted were perfect.<sup>24</sup> Rather, Justice Brennan argued that the insurance exemption existed because there were insurance financial products that state insurance regulators were better designed to deal with than the SEC. In his view, the test for whether a financial product is a security to be regulated by the SEC or an insurance product to be regulated by the states should depend upon whether the product poses the kind of challenges that were being dealt with either by the 1933 Securities Act or by the state insurance regulations that existed at the time the Securities Act was passed.<sup>25</sup>

When he fleshed out this test, Justice Brennan asserted that the purpose of the 1933 Act was primarily to ensure disclosure to investors.<sup>26</sup> He said that “the philosophy of the Act is that full disclosure of the details of the enterprise in which the investor is to put his money should be made so that he can intelligently appraise the risks involved.”<sup>27</sup> According to Justice Brennan, state insurance regulation of annuities is different in that the focus of annuities regulation is, first, to interpret contractual terms, and second, to ensure that the insurance companies are solvent and have adequate financial reserves capable of paying out the benefits that they are obligated to pay under the policies.<sup>28</sup> According to the nature of fixed annuities at the time the 1933 Act was created, there was no need for disclosure relating to fixed annuities, whereas there was a strong need for solvency and reserves regulation of fixed annuities.<sup>29</sup> Therefore, because the annuities at the time the Act was passed did not require disclosure regulation, and the purpose of the 1933 Securities Act was primarily to enforce disclosure, the insurance exemption made perfect sense.<sup>30</sup>

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<sup>23</sup> SEC v. Variable Annuity Life Ins. Co. of Am. (VALIC), 359 U.S. 65, 73 (1959) (Brennan, J., concurring).

<sup>24</sup> *Id.* at 75.

<sup>25</sup> *Id.* at 75-76.

<sup>26</sup> *Id.* at 77.

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> VALIC, 359 U.S. at 77.

<sup>30</sup> *See id.*

Applying his analysis to variable annuities, Justice Brennan held that because variable annuity insureds are exposed to the investment management of the insurers, the disclosure regulations of the 1933 Securities Act were highly relevant, and the contractual, solvency and reserves regulations of state insurance regulation were not.<sup>31</sup> Justice Brennan, while arguing that the variable annuities also fall under the scope of the Investment Company Act of 1940, said “[t]hese are the basic protections that Congress intended investors to have when they put their money into the hands of an investment trust; there is no adequate substitute for them in the traditional regulatory controls administered by state insurance departments. . . .”<sup>32</sup> In footnote 26, Justice Brennan notes that the “least-subtle” example of an area that state regulators are not equipped to cope with is “investment policy,” in that the states do not regulate how the variable annuity insurers invest the premiums, which stocks they may invest in, and when they are allowed to change their investing strategy.<sup>33</sup>

Justice Brennan astutely opined that “[m]uch bewilderment could be engendered by this case if the issue were whether the contracts in question were ‘really’ insurance or ‘really’ securities—one or the other. It is rather meaningless to view the problem as one of pigeonholing these contracts in one category or the other,” because what matters is the relevance of state insurance or Federal securities regulation, and not the intrinsic essence of the product itself.<sup>34</sup> Despite his rejection of any effort to classify the essence of the product, Justice Brennan took the time to explore the features of the product at issue in great detail and based his analysis of the relevance of Federal or state regulation on what he found the product’s risks to consist of.<sup>35</sup> Summarizing the theory of the concurrence, Justice Brennan’s paradigm of what constitutes insurance is quite different from the majority: it turns not on the risk-shifting nature of the product, but rather on the presence of risks that state insurance regulation seeks to address (i.e., solvency and contract interpretation).

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<sup>31</sup> *Id.* at 78-80.

<sup>32</sup> *Id.* at 85.

<sup>33</sup> *Id.* at 86 n.26.

<sup>34</sup> *Id.* at 80.

<sup>35</sup> *See VALIC*, 359 U.S. at 81-85.

### 3. Justice Harlan's Dissent

In *VALIC*, Justice Harlan authored a spirited dissent in which he began by observing that the insurance exemption codified a longstanding tradition that insurance regulation belonged to the states and not to the Federal government.<sup>36</sup> Although the dissent failed to adequately address the arguments raised in the majority opinion and the concurrence, it did make an interesting argument, typified by two quotes, the first of which is: “[Congress’ intent that the states regulate insurance] in my view demands that bona fide experiments in the insurance field, even though a particular development may also have securities aspects, be classed within the federal exemption of insurance, and not within the federal regulation of securities.”<sup>37</sup> The second quote, which evinces a strong state’s rights view, is:

It is asserted that state regulation, as it existed when the Securities and Investment Company Acts were passed, was inadequate to protect annuitants against the risks inherent in the variable annuity and that therefore such contracts should be considered within the orbit of SEC regulation. The Court is agreed that we should not ‘freeze’ the concept of insurance as it then existed. By the same token we should not proceed on the assumption that the thrust of state regulation is frozen. As the insurance business develops new concepts the States adjust and develop their controls. This is in the tradition of state regulation and federal abstention. If the innovation of federal control is nevertheless to be desired, it is for the Congress, not this Court, to effect.<sup>38</sup>

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<sup>36</sup> *SEC v. Variable Annuity Life Ins. Co. of Am. (VALIC)*, 359 U.S. 65, 97 (1959) (Harlan, J., dissenting). The dissent quoted portions of the legislative history showing that Congress had been concerned because at the time the Act was passed it was debatable whether the Federal Government could regulate insurance under the Commerce Clause power. *See* 77 CONG. REC. 2935-39, 2945-46, 3109 (1933).

<sup>37</sup> *VALIC*, 359 U.S. at 100.

<sup>38</sup> *Id.* at 100-01.

Thus, although the dissent did not delve into the ways in which contemporary state insurance regulation might be adequate to regulate the investment aspect of variable annuities, Justice Harlan argued that experiments could be classified as insurance, and should be so classified given the strong history of state regulation of insurance. He also argued that there is every possibility that state insurance, if capable of evolution and not frozen in the form it consisted of in 1933, might actually become competent to regulate quasi-security products.<sup>39</sup> Justice Harlan's theory of insurance seems to be that any time an insurance company launches a bona fide experiment, the resulting product is insurance. In other words, the defining feature of insurance is the involvement of an insurance company, not the risk-shifting nature of the product (as in the *VALIC* majority's theory) or the risks being regulated (as in Justice Brennan's theory).

### C. *UNITED BENEFIT*

In *United Benefit*, the United States Supreme Court was tasked with evaluating a new quasi-security product called a Flexible Funds annuity and deciding whether it qualified for the insurance exemption.<sup>40</sup> The annuity in question greatly resembled a variable annuity in that the premiums, less a deduction for expenses (namely the net premiums,,), were held in a separate account and were invested primarily in common stocks for the purpose of both interest returns and capital gains.<sup>41</sup> The annuity differed from prior variable annuities in that a percentage of net premiums, which increased over the life of the contract from 50% in year one to 100% in year ten, was guaranteed to be paid back to the insured, although the product did not guarantee a rate of interest.<sup>42</sup> The Court held that Flexible Funds annuities do not qualify for the insurance exemption even though part of the payments were fixed, for several reasons.

First, the Court argued that because the aspect of the payments that were fixed could have been offered separately from the investment aspect of the product, the fixed aspect was conceptually separable from the variable investment-related payments and the two aspects could be

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<sup>39</sup> *Id.*

<sup>40</sup> *SEC v. United Benefit Life Ins. Co. (United Benefit)*, 387 U.S. 202, 204 (1967).

<sup>41</sup> *Id.* at 205.

<sup>42</sup> *Id.* at 205-06.

considered and analyzed separately.<sup>43</sup> Secondly, the Court found that the products were marketed for growth and were “considered to appeal to the purchaser not on the usual insurance basis of stability and security but on the prospect of ‘growth’ through sound investment management.”<sup>44</sup> Third, the Court held that the product was not insurance because it was an insured, i.e., hedged),) contract rather than a contract of insurance, and the mere assumption of investment risk did not create insurance.<sup>45</sup> The Court cited *Helvering* in support of this proposition and used that citation to argue that the Flexible Fund was not insurance even though the insurer’s guarantee of a return of principal reduced somewhat the insured’s risk. *Helvering* formed the basis of this distinction, meaning that risk-shifting and risk-distributing seem to be a factor in distinguishing an insured (hedged) contract from an insurance contract.<sup>46</sup>

The *United Benefit* Court cited with approval Justice Brennan’s *VALIC* concurrence, and claimed that under Brennan’s analysis the purchasers of Flexible Funds were seeking “growth through professionally managed investment,” and were comparable to purchasers of mutual funds and, therefore, entitled to SEC regulations governing disclosure.<sup>47</sup> The Court in *United Benefit* appeared to espouse the theory of insurance embodied in Justice Brennan’s *VALIC* concurrence in that disclosure was the relevant regulatory challenge for the growth and investment management aspects of the Flexible Funds and its regulatory risk determined whether the product was insurance.<sup>48</sup>

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<sup>43</sup> *Id.* at 209.

<sup>44</sup> *Id.* at 211.

<sup>45</sup> *Id.* The contract was hedged in the sense that some portion of the investment was guaranteed.

<sup>46</sup> *United Benefit*, 387 U.S. at 211; *see supra* notes 9-10 and accompanying text.

<sup>47</sup> *United Benefit*, 387 U.S. at 210-11.

<sup>48</sup> The *United Benefit* Court also cited *C.M. Joiner* for the proposition that a relevant test of a security is “what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect,” and found that this test showed that the product was a security because it was marketed for growth rather than stability and security. *Id.* at 211.



### III. THE RISE OF FIXED INDEX ANNUITIES AND SEC'S RESPONSE

Fixed index annuities are a type of financial product that first took off in the 1990s. The SEC has attempted to regulate fixed index annuities, taking differing approaches to regulation at different times. This section will explain what fixed index annuities are and trace the SEC's regulatory response.

#### A. THE THEORY BEHIND INDEX INVESTING

In order to understand the nature of fixed index annuities it is important to understand the investment theory behind index investing. Index investing employs the strategy of passively investing in a securities index (which is a very large group of stocks taken to represent the market as a whole, for example the S&P 500, which consists of 500 stocks, or the Russell 2000, which contains 2000 stocks) instead of picking individual stocks. The theoretical basis for index investing is based upon two schools of financial thought: Modern Portfolio Theory (also known as MPT) and Capital Asset Pricing Model (also known as CAPM).<sup>49</sup> Modern Portfolio Theory, first developed by Harry Markowitz,<sup>50</sup> essentially boils down to the proposition that the best way to reduce the risk inherent in a portfolio of stocks is to diversify (in other words, to purchase a multitude of stocks each of which will perform differently under different conditions so that at any given time the odds are that some of the stocks in the portfolio will be doing well and, therefore, the odds of the portfolio as a whole doing well will increase,,),, and to the corollary proposition for investing strategy that a diversified portfolio is superior to a non-diversified portfolio from the point of view of managing uncorrelated risk.<sup>51</sup>

Modern Portfolio Theory later evolved into a new financial theory called Capital Asset Pricing Model, developed by William Sharpe among

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<sup>49</sup> See BURTON G. MALKIEL, *A RANDOM WALK DOWN WALL STREET* 183-210 (4th ed. 1985).

<sup>50</sup> See generally Harry M. Markowitz, *Portfolio Selection*, 7 J. FIN. 77 (1952) (presenting what is widely viewed as the original presentation of Modern Portfolio Theory).

<sup>51</sup> See MALKIEL, *supra* note 49, at 193-99.

others.<sup>52</sup> Capital Asset Pricing Model introduced the idea of “beta,” a mathematical statistical quantification of market risk, also called the systematic risk.<sup>53</sup> The Capital Asset Pricing Model posits that the risk that is specific to an individual stock—the non-beta risk—can be diversified away by building a diversified portfolio based on sound statistical and mathematical models with other stocks that counterbalance the risk of the first stock. At the same time, CAPM asserts that each stock also contains a risk inherent in the individual stock which cannot be diversified away, which is risk that comes from the relation of the stock to the market as a whole; that risk is called beta.<sup>54</sup> An example of non-beta risk is the risk that a specific public company will have incompetent or dishonest management. Beta quantifies the risk that a stock will go up or down because the market as a whole goes up or down.<sup>55</sup> The Capital Asset Pricing Model modifies the general investing principal that more risk earns greater reward to assert that more beta should earn greater reward, but more non-beta risk should not earn more reward because any competent investor can diversify all non-beta risk away and be left only with beta risk.<sup>56</sup>

The Modern Portfolio Theory and Capital Asset Pricing Model became fashionable in the 1970s.<sup>57</sup> The MPT/CAPM theory, with its strong emphasis on diversification, is the theoretical structure that gave rise to index investing.<sup>58</sup> Index investing seeks to accomplish as much diversification as possible and to diversify to the point of having only systematic beta risk and eliminating non-beta risk by buying the stocks of an index, such as the S&P 500, which is a collection of 500 reputable stocks that is generally used as a measure of the performance of the stock market as a whole.

The theory of index investing is that by buying an index one assumes beta, the risk that the market as a whole will go up or down, but avoids the individualized risks inherent in each stock that comprises the market. The reasoning is that one can avoid non-beta risk without any loss

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<sup>52</sup> See generally William F. Sharpe, *Capital Asset Prices: A Theory of Market Equilibrium Under Conditions of Risk*, 19 J. FIN. 425 (1964) (presenting what is usually viewed as a substantial contribution to the creation of Capital Asset Pricing Model).

<sup>53</sup> See MALKIEL, *supra* note 49, at 199-209.

<sup>54</sup> See *id.*

<sup>55</sup> See *id.*

<sup>56</sup> See *id.*

<sup>57</sup> *Id.* at 208-09.

<sup>58</sup> *Id.* at 322.

in returns, and therefore sensibly risk-averse investors will do so; however, one cannot avoid the risk that the market as a whole will go up or down because every stock's beta inextricably ties it to the market, and therefore beta is the only risk that a sensible investor will assume.

The index investing philosophy believes that it is impossible to beat the market average, i.e., the index, by picking stocks. This is because the movements of individual stocks are random, the stock market is efficient and therefore stocks are usually priced correctly and rarely present opportunities to buy undervalued stocks or sell overvalued stocks, and the costs of picking stocks exceed the costs of passive investment.<sup>59</sup> It is important to understand that index investing, unlike most investing strategies, is not a strategy for choosing the right stocks, and does not purposefully assume any of the risks inherent in choosing stocks. It is a strategy that foregoes choosing individual stocks and chooses to invest only in the market as a whole as a way to eliminate the risks inherent in choosing individual stocks and to grow one's money as the economy grows. The fundamental idea behind index investing is diversification as a means of reducing financial risk. This matters because an investment strategy devoid of stock-picking does not pose the same regulatory challenges as traditional investing.

#### B. THE RISE OF INDEX INVESTING PRODUCTS

Given that MPT/CAPM and the associated postulates of index investing hold that one can and should diversify all non-beta risk away, that it is impossible to beat the indexes by picking stocks, and that the market can only go up over the long term, it follows from this investing philosophy that a smart investor, instead of choosing individual stocks, should simply buy the market. Doing so reduces or eliminates the risks associated with picking stocks and hopefully allows one's money to keep pace with the growth of the market over the long term. In the 1970s, Wall Street saw the demand for financial products designed to satisfy believers in MPT/CAPM, and Wall Street gave birth to the index mutual funds, including mutual funds that allowed small individual investors to invest according to an

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<sup>59</sup> See MALKIEL, *supra* note 49, at 129-33, 174-76. See also CHARLES R.T. O'KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS 201-05 (5th ed. 2006).

index such as the S&P 500.<sup>60</sup> By 2007, the fixed index annuity market had grown such that there were 322 fixed index annuities offered by 58 different insurance companies, and at that time the collective sales volume of fixed index annuities was \$24.8 billion, and fixed index annuity assets had reached \$123 billion.<sup>61</sup> Since their inception, index mutual funds have become very popular, with at least \$255 billion invested in S&P 500 index mutual funds as of June 2005.<sup>62</sup>

Life insurance companies began to offer fixed index annuities in 1995.<sup>63</sup> There are many kinds of fixed index annuities with different features, but generally a fixed index annuity is an annuity in which the insured makes payments to the insurer, and the insurer guarantees a return of some percentage of the principal plus a minimum percentage interest rate of return, similar to a fixed annuity. In addition, a fixed index annuity offers the possibility for a higher percentage rate of return in excess of the guaranteed rate of return, calculated by reference to the annual growth of an equity index, although the formula used to calculate the excess rate can be complicated.<sup>64</sup> A fixed index annuity is similar to an index mutual fund in that both offer returns based on the performance of indexes, but there are also differences between the two. The purchaser of a mutual fund suffers the risk that if the index goes down he will lose money, whereas the owner of a fixed index annuity does not risk loss below the guaranteed levels.<sup>65</sup> In addition, an index mutual fund actually invests the purchaser's money in the stocks comprising the index, whereas a fixed index annuity insurer is free to invest the insured's payments however it wishes so long as it ends up with enough money to pay the insured the amounts that he is owed under the policy.<sup>66</sup>

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<sup>60</sup> See MALKIEL, *supra* note 49, at 322-23; see Gary O. Cohen, *Indexed Insurance Products Versus Index Mutual Funds: Status Under the Federal Securities Laws 2007*, 1596 PRACTICING L. INST. CORP. L. & PRAC. COURSE HANDBOOK SERIES 507, 515-16 (2007).

<sup>61</sup> *Am. Equity Inv. Life Ins. Co. v. SEC*, 572 F.3d 923, 928 (D.C. Cir. 2009), *amended by* 2010 U.S. App. LEXIS 14249 (D.C. Cir. July 12, 2010).

<sup>62</sup> See Cohen, *supra* note 60, at 517.

<sup>63</sup> *Id.* at 518.

<sup>64</sup> See *id.* at 526-43.

<sup>65</sup> *Id.* at 511-12.

<sup>66</sup> *Id.*

## C. THE SEC'S EFFORTS TO REGULATE FIXED INDEX ANNUITIES

The SEC's approach to regulating fixed index annuities has changed and evolved considerably over the last twenty years. Beginning in 1986 fixed index annuities were covered by Rule 151, which is a "safe harbor" SEC regulation under which insurance products meeting certain conditions are considered to be insurance not subject to the 1933 Securities Act.<sup>67</sup> Rule 151 provides that:

(a) Any annuity contract or optional annuity contract (*a contract*) shall be deemed to be within the provisions of section 3(a)(8) of the Securities Act of 1933 (15 U.S.C. 77c(a)(8)), *Provided, That*

(1) The annuity or optional annuity contract is issued by a corporation (the insurer) subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia;

(2) The insurer assumes the investment risk under the contract as prescribed in paragraph (b) of this section; and

(3) The contract is not marketed primarily as an investment.

(b) The insurer shall be deemed to assume the investment risk under the contract if:

(1) The value of the contract does not vary according to the investment experience of a separate account;

(2) The insurer for the life of the contract

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<sup>67</sup> Gary O. Cohen, *SEC Regulation of Index Annuities Versus Index Mutual Funds*, 1732 PRACTICING L. INST. CORP. L. & PRAC. COURSE HANDBOOK SERIES 699, 727 (2009).

(i) Guarantees the principal amount of purchase payments and interest credited thereto, less any deduction (without regard to its timing) for sales, administrative or other expenses or charges; and

(ii) Credits a specified rate of interest as defined in paragraph (c) of this section to net purchase payments and interest credited thereto; and

(3) The insurer guarantees that the rate of any interest to be credited in excess of that described in paragraph (b)(2)(ii) of this section will not be modified more frequently than once per year.<sup>68</sup>

The application of Rule 151 to fixed index annuities was relatively uncertain from 1986 until 2008. In 1997 the SEC, having learned of the growth of fixed index annuities since 1995, issued a concept release seeking comments as to how it should regulate the new financial products.<sup>69</sup> But the SEC did not follow the comment process by immediately promulgating a rule, and in the wake of SEC's silence the industry assumed that fixed index annuities could qualify for the insurance exemption on a case-by-case basis, an approach that was tacitly approved by the SEC in a statement on the SEC website.<sup>70</sup>

The SEC proposed Rule 151A, a new rule which defined fixed index annuities as securities unless they met a specific set of requirements, in June of 2008.<sup>71</sup> After two separate comment periods in 2008, during which the issue of fixed index annuity regulation led to divisive debate in the insurance community, the SEC adopted Rule 151A by a vote of four to one in December of 2008.<sup>72</sup> The rule takes effect in January 2011.<sup>73</sup>

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<sup>68</sup> 17 C.F.R. § 230.151 (2009).

<sup>69</sup> See Cohen, *supra* note 60, at 518.

<sup>70</sup> *Id.* at 518-19.

<sup>71</sup> Cohen, *supra* note 67, at 711.

<sup>72</sup> *Id.* at 711-13.

<sup>73</sup> *Id.* at 715.

The text of Rule 151A provides that:

(a) *General.* Except as provided in paragraph (c) of this section, a contract that is issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia, and that is subject to regulation under the insurance laws of that jurisdiction as an annuity is not an “annuity contract” or “optional annuity contract” under Section 3(a)(8) of the Securities Act (15 U.S.C. 77c(a)(8)) if:

(1) The contract specifies that amounts payable by the issuer under the contract are calculated at or after the end of one or more specified crediting periods, in whole or in part, by reference to the performance during the crediting period or periods of a security, including a group or index of securities; and

(2) Amounts payable by the issuer under the contract are more likely than not to exceed the amounts guaranteed under the contract.<sup>74</sup>

A summary of Rule 151A is that to be insurance a fixed index annuity must calculate its excess rate of return at or after the conclusion of the time period during which the index’s performance is measured, and it must be probable that the majority of money paid to the fixed index annuity owner will be guaranteed (i.e., will not come from the index-linked excess rate of return).<sup>75</sup> The SEC’s adopting release on the Federal Register seems

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<sup>74</sup> 17 C.F.R. § 230.151A(a) (2009). The exception in paragraph (c) of Rule 151A states that “[t]his section does not apply to any contract whose value varies according to the investment experience of a separate account.” § 230.151A(c).

<sup>75</sup> § 230.151A.

to suggest that the centerpiece of the rule is the “more likely than not” test, which was designed to express SEC’s belief, based on its interpretation of *VALIC*, that if the majority of payout is guaranteed then the insurer bears the majority of the risk and the financial product is therefore insurance, whereas if the majority of the payout is not guaranteed then the insured bears the majority of the risk and the product is therefore a security.<sup>76</sup>

#### IV. CONTEMPORARY CASES APPLYING INSURANCE EXEMPTION JURISPRUDENCE TO FIXED INDEX ANNUITIES

There is scant case law to date on whether fixed index annuities are insurance and thus exempt from regulation under the 1933 Act. The status of fixed index annuities has been addressed in two recent cases. The first was *Malone v. Addison Insurance Marketing Inc.*, a 2002 case in federal district court in Kentucky in which the court held that fixed index annuities qualified for the § 3(a)(8) insurance exemption and also met the criteria to qualify under the Rule 151 safe harbor.<sup>77</sup> The second case is *American Equity Investment Life Insurance Co. v. SEC*, a case in which a coalition of life insurance companies challenged the SEC’s Rule 151A in the D.C. Circuit in 2009.

##### A. *MALONE*

*Malone* was a case in which a plaintiff claimed securities fraud in her purchase of fixed index annuities, requiring the U.S. District Court for the Western District of Kentucky to decide whether her fixed index annuities were securities or were exempt under the insurance exemption.<sup>78</sup> The court focused on *VALIC* and *United Benefit* as the two controlling cases, and phrased its task as one of determining whether the contract at issue operates more like a variable or fixed annuity.<sup>79</sup> The court quoted the United States Supreme Court as saying that “in searching for content in the term ‘security,’ ‘form should be disregarded for substance and the

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<sup>76</sup> See Indexed Annuities And Certain Other Insurance Contracts, 74 Fed. Reg. 3138, 3141-44 (Jan. 16, 2009) (to be codified at 17 C.F.R. Pts. 230 and 240).

<sup>77</sup> *Malone v. Addison Ins. Mktg. Inc.*, 225 F. Supp. 2d 743 (W.D. Ky. 2002).

<sup>78</sup> *Id.* at 745-48.

<sup>79</sup> *Id.* at 748-49.



emphasis should be on economic reality.”<sup>80</sup> The court discussed *VALIC* and *United Benefit* and focused on whether the insured was exposed to investment risk, and whether the insurer guaranteed a fixed dollar amount for the insured, as factors in determining risk in the insurance sense.<sup>81</sup> The court then had this to say:

Plaintiff's effort, therefore, to classify her American Equity contracts as the sale of a variable annuity fails for several reasons. First, Plaintiff's two contracts with American Equity *guaranteed* her a minimum 3 percent return, irrespective of the performance of the S & P 500 Index. As the Benefit Summary and Disclosure form states, the annuity contracts were “designed to accumulate value based on the average change in the S & P 500 Equity Index during each contract year, without risking loss of premium due to the S & P volatility.” In other words, in the event the S & P 500 performed poorly, Plaintiff still received a 3 percent interest payment on top of her principal annually. Consequently, American Equity assumed the investment risk and not Plaintiff who received payment regardless of how poorly the market performed.

Second, Plaintiff's benefit payments from American Equity were not directly dependent on the performance of investments made with her money. That is to say, as a structural matter, Plaintiff's contract did not operate like a variable annuity: her payments were not a function of a personalized portfolio and her principal was not held in an independent account. Had Plaintiff participated in a variable annuity, she would have retained control over the investment of her account. In this case, Plaintiff paid American Equity lump sum premiums in the amount of \$216,289.53 and \$64,214.32 and signed a contract that guaranteed her a 3 percent return or more if the S & P 500 Index fared well. Moreover, at no point does Plaintiff's complaint allege that her premiums were maintained in separate accounts or that, for some reason, they should

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<sup>80</sup> *Id.* at 748 (quoting *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967)).

<sup>81</sup> *Id.* at 749-50.

have been-the keystone characteristic of all variable annuity contracts.<sup>82</sup>

Thus, the *Malone* court held that because both principal and interest were guaranteed, the insurer had assumed a risk sufficient to constitute insurance and the insured was not exposed to the risk of the index performing poorly, and because there was no separate account that invested the insured's money, the insured was not exposed to investment risk.<sup>83</sup> The *Malone* court then went on to address and refute an argument which the *American Equity* court later found to be dispositive in reaching an opposite result, the argument being that because the potential for increased returns was tied to the performance of the S&P 500 that the insured was exposed to a securities-like investment risk. The *Malone* court said:

Finally, Plaintiff focuses on the fact that her return over and above the guarantee depended on the performance of the S & P 500 Index. In that way, her annuity contract did involve an element of risk and uncertainty. However, this argument is not conclusive for Plaintiff in these circumstances. Defendants actually bore as much or more of the risk than Plaintiff. American Equity guaranteed Plaintiff at least three percent of the return on the S & P 500 Index based on whichever was greater. If American Equity was unable to surpass this indexed rate in its own investment of the Plaintiff's premium, then it was the loser. More importantly, Plaintiff's risk was not that she would lose the value of her initial investment, but rather the risk that had she chosen a different contract her money might have been worth more than 134 percent at the end of the ten-year contract period. That type of risk-that she could have gotten a better deal but for the pressure she encountered to enter into this particular contract-is not the type of risk central to determining whether a security exists. See *VALIC*, 359 U.S. at 71, 79 S.Ct. 618 (noting that "it is no answer to say that the risk of declining returns in times of depression is the reciprocal of the fixed-dollar

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<sup>82</sup> *Id.* at 750.

<sup>83</sup> *Malone*, 225 F. Supp. 2d at 750.

annuitant's risk of loss of purchasing power when prices are high and gain of purchasing power when they are low"). Because the Defendants assumed a much greater risk, Plaintiff's Investment seems a lot more like insurance and less like an investment for the Plaintiff.<sup>84</sup>

The court seems to be saying that because the principal and interest were guaranteed, the risk of loss from the index not performing well was smaller than the reduction in risk that came from the guaranteed portions of the contract. The court also implies that the risk that the index will not perform well enough to increase the payout is not the risk that the insured will lose her money, it is the risk that if she had invested in a different financial product she might have made more money. Here we see a hint of the question of whether the risk of not receiving a benefit is the same as the risk of suffering a loss. The *Malone* court seems to think that it is not; I will argue later that the question is debatable but that the *Malone* approach is preferable.

The *Malone* court went on to also hold that the fixed index annuity in question satisfied the Rule 151 safe harbor.<sup>85</sup> This part of the opinion is interesting mainly because the court, after examining the product's insurance contract and sales brochure, found that the fixed index annuity had been marketed primarily for stability and security and not primarily for growth.<sup>86</sup> The court, although it did not address the issue explicitly, noticed no difference between setting the index rate before the annual period or after the annual period for the purpose of meeting the safe harbor requirement that the index rate be set annually.<sup>87</sup>

#### B. *AMERICAN EQUITY*

*Malone* did not decide the validity of Rule 151A, having been decided six years before. In 2009, after the promulgation of Rule 151A, a coalition of insurers, joined by the National Association of Insurance Commissioners, sued to overturn the SEC's Rule 151A, culminating in the D.C. Circuit's opinion in *American Equity Investment Life Insurance Co. v.*

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<sup>84</sup> *Id.* at 751.

<sup>85</sup> *Id.* at 751-54.

<sup>86</sup> *Id.* at 753-54.

<sup>87</sup> *Id.* at 753.

SEC.<sup>88</sup> The petitioners argued that the SEC's Rule 151A conflicted with the plain language of the insurance exemption in the 1933 Act, that it was not supported by *VALIC* and *United Benefit*, and that it contradicted the prior Rule 151, and the petitioners additionally made an administrative procedural argument about the promulgation of Rule 151A.<sup>89</sup> The court applied the *Chevron* two-step test that would affirm the rule if, as the first step, the statute in question was ambiguous, and, as the second step, the SEC as the agency interpreting the statute offered a reasonable interpretation.<sup>90</sup> The court held that both steps were satisfied and affirmed the SEC's Rule 151A, based on the Supreme Court's decisions in *VALIC* and *United Benefit*.<sup>91</sup> In particular, the *American Equity* court placed a great deal of emphasis on *VALIC*'s holding that a variable annuity is not insurance because the concept of insurance involves investment risk-taking on the part of the insurer, that all the investment risk was on the insured and none was on the insurer, and that the variable annuity insurer assumes no true risk in the insurance sense.<sup>92</sup> The court took *United Benefit* to stand for the proposition that a financial product marketed for growth rather than stability and security is not insurance.<sup>93</sup>

The *American Equity* court wholeheartedly accepted SEC's characterization of the facts in the case, specifically SEC's analysis of the nature, function and appeal of fixed index annuities.<sup>94</sup> According to the SEC, the buyer of a fixed index annuity is "exposed to a significant investment risk-*i.e.*, the volatility of the underlying securities index," the insured "assumes the risk of an uncertain and fluctuating financial instrument, in exchange for participation in future securities-linked returns," and "an FIA's return was neither known nor guaranteed."<sup>95</sup> The SEC asserted that the fixed index annuity's guarantees as to principal and interest rate were "superficial and unsubstantial" and they did not shift the

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<sup>88</sup> *Am. Equity Inv. Life Ins. Co. v. SEC*, 572 F.3d 923, 925 (D.C. Cir. 2009), *amended by* 2010 U.S. App. LEXIS 14249 (D.C. Cir. July 12, 2010).

<sup>89</sup> *Id.* at 929-30.

<sup>90</sup> *Id.* at 930-31.

<sup>91</sup> *Id.* at 926-27, 930-31, 934.

<sup>92</sup> *Id.* at 926.

<sup>93</sup> *Id.* at 927.

<sup>94</sup> *Am. Equity Inv. Life Ins. Co.*, 572 F.3d at 928-29.

<sup>95</sup> *Id.* (quotation marks omitted) (quoting Indexed Annuities And Certain Other Insurance Contracts, 74 Fed. Reg. 3138 (Jan. 16, 2009) (to be codified as 17 C.F.R. Pts. 230 and 240)).

investment risk to the insurer.<sup>96</sup> While the court mentioned that fixed index annuities do not entail any investment management, it said that this was not the only relevant factor in the analysis.<sup>97</sup>

The court agreed with the SEC's argument that the fixed index annuity's guarantee did not eliminate risk because the apt comparison was between a traditional fixed annuity guaranteeing a five percent interest rate and a fixed index annuity guaranteeing a one percent interest rate with a potential for an index-based ten percent interest rate, such that the fixed index annuity which fluctuates from one to ten percent was obviously far more risky than the traditional fixed annuity which remains stable at five percent, even though some rate of interest was guaranteed by the fixed index annuity.<sup>98</sup> The court accepted this argument in response to petitioner's challenge that the SEC used an unreasonable definition of risk.

The insurers in *American Equity* and their amici argued that SEC's definition of risk is irrational because risk is loss of principal and it is arbitrary that an annuity with a guaranteed minimum return is less risky than the same annuity with that minimum plus a chance at a higher return tied to an index. The flaw is their argument, and the reason the court did not buy it, is that it does not analyze risk in terms of the function of an insurance contract. It is also problematic because the court believed that the insured would have to pay higher premiums to gain access to index-based rewards than those in a comparable non-indexed annuity.

Obviously for the analogy between a five percent rate of return and a rate of return between one and ten percent to be persuasive the court must have believed that the risk of not receiving a benefit is the same risk as the risk of suffering a loss. The court held that how a product is marketed is not a necessary component of insurance exemption analysis, even though it was central to *United Benefit*.<sup>99</sup> The court nonetheless found that the fixed index annuities were being marketed as securities, although this finding was based not on empirical data but on the *a priori* analysis that because the product entailed investment risk it was therefore surely being marketed as a security.<sup>100</sup>

The court accepted the SEC's analysis along the lines of Justice Brennan's *VALIC* concurrence that fixed index annuities were better suited

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<sup>96</sup> *Id.* at 929.

<sup>97</sup> *Id.* at 930-31.

<sup>98</sup> *Id.* at 931.

<sup>99</sup> *Id.* at 933.

<sup>100</sup> *Am. Equity Inv. Life Ins. Co.*, 572 F.3d at 933.

to be regulated by federal securities regulators than by state insurance regulators. But the court did not look at the risks necessitating disclosure as opposed to the risks necessitating solvency and reserves requirements as Justice Brennan had done. Instead it looked only at whether the product was a risky product or a no-risk product.<sup>101</sup> The court, in response to the petitioner's argument that Rule 151A contradicted Rule 151, held that fixed index annuities do not fall under the Rule 151 safe harbor requirements, because according to the court's interpretation of Rule 151 the interest rate for the annual period had to be set prospectively at the beginning of the annual period.<sup>102</sup>

After affirming the SEC's decision that fixed index annuities are not insurance, the *American Equity* court proceeded to address a second issue, whether Rule 151A's rulemaking was arbitrary and capricious under the Administrative Procedure Act. The court found that it was arbitrary because SEC had failed to properly conduct an analysis of Rule 151A's effects upon efficiency, competition, and capital formation, and also because the purpose that SEC claimed for its Rule 151A, namely that it would provide clarity and certainty, would have been provided by any rule.<sup>103</sup> The court initially remanded the case for SEC to complete the proper economic analysis.<sup>104</sup> However, in July 2010 the D.C. Circuit amended the decision in an unreported opinion, changing only the final paragraph of the prior opinion and ordering that Rule 151A be vacated.<sup>105</sup> The court observed that the SEC had argued that it was likely to reissue Rule 151A, but noted that SEC's analysis of the rule's effects upon state law had not yet been completed.<sup>106</sup> The SEC has refused to say whether it will reissue Rule 151A and has refused to comment on the legal status of fixed index annuities in the wake of Rule 151A's being vacated, so one can presume that the current legal status of fixed index annuities is uncertain.<sup>107</sup>

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<sup>101</sup> *Id.* at 928. The court also interpreted Justice Brennan's concurrence to mean that the presence or absence of adequate state regulation is irrelevant to insurance exemption analysis. *Id.* at 931.

<sup>102</sup> *Id.* at 933-34.

<sup>103</sup> *Id.* at 934-36.

<sup>104</sup> *Id.* at 936.

<sup>105</sup> *Am. Equity Inv. Life Ins. Co. v. SEC*, 2010 U.S. App. LEXIS 14249, at \*2-4 (D.C. Cir. July 12, 2010).

<sup>106</sup> *Id.* at \*3.

<sup>107</sup> Telephone Interview with John Heine, Deputy Dir., SEC Office of Pub. Affairs (Sept. 17, 2010).

V. WHY *AMERICAN EQUITY* WAS MISTAKEN IN HOLDING THAT FIXED INDEX ANNUITIES ARE NOT INSURANCE

Although petitioners won the *American Equity* case based on procedural grounds, ultimately their victory may be pyrrhic if the SEC cures the procedural defects. In this section I argue why, from a purely legal point of view applying the relevant precedent to the facts of the case, the *American Equity* opinion's decision that fixed index annuities are not insurance was wrongly decided. I will then outline the various policy justifications for leaving regulation of fixed index annuities to the states.

A. LEGAL ARGUMENTS

1. The VALIC Argument

The risk that is transferred in a fixed annuity from the insured to the insurer is the risk of picking stocks when investing for retirement. This is the same risk that is transferred with a fixed index annuity. In a variable annuity, the insured bears the stock-picking risk of the insurer; with a fixed index annuity the risk of picking stocks is eliminated.

Risk-reward analysis may be useful to understand what is the reduction of risk in the insurance sense, which was key to the VALIC majority opinion.<sup>108</sup> The fundamental principle that ties insurance and securities together is the principle that to earn a greater reward you must assume more risk. A security is an assumption of more risk in exchange for a higher potential reward. An insurance policy is a reduction in risk bought in exchange for a reduction in reward (i.e. you get less money in return for a lower reward). Quasi-security insurance products do not fit neatly into either category but can be examined using the same analysis. A traditional fixed annuity provides a full guaranteed return that is lower due to the buyer's reduced risk. This is why it makes sense to fall under the insurance exception. In a variable annuity in contrast, the buyer assumes higher risk—in the form of investment risk—in exchange for greater reward in the future, but more risk is in exchange for greater reward. This makes it a security. On its surface, a fixed index annuity appears to involve an assumption of market risk in exchange for greater reward. As such it may be interpreted as a security. In fact, however, its purpose is to eliminate non-beta risk, so like a fixed annuity its purpose is actually the reduction of

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<sup>108</sup> See *supra* text accompanying note 20.

risk, via the transfer of risk to the insurer. From the buyer's point of view, he: (1) shifts the non-beta risk to the insurer, and (2) reduces some beta risk via the guarantee (absent the insurer's insolvency).<sup>109</sup>

If a person saving for retirement himself could not use insurance products and had to save for retirement, he would have to invest in equities to keep pace with inflation, and he would bear the risk that those investments would decrease in value. This risk, the risk of investing for retirement and of suffering losses if one incorrectly chooses stocks while investing for retirement, which can also be called the risk of investment management, is precisely the risk that is transferred to the insurer from the insured with a fixed index annuity. The insurer bears the non-beta risk of investing, not the buyer. This risk is not transferred with variable annuities that are invested in actively managed stocks, because the insured continues to bear non-beta risk.

With a fixed index annuity, the buyer transfers his non-beta risk to the insurer and keeps only the beta risk, i.e., that the economy will irrevocably collapse. The insurer then takes the risk of investing the insured's money from the insured. It is not the guarantee of being paid a certain percentage of premiums that makes it insurance, and indeed the Supreme Court's jurisprudence precludes such an argument. The fact that the insurer bore some risk was not sufficient to create insurance under the *VALIC* analysis in *United Benefit*, and I would argue that it is not the insurer's bearing risk but rather the insurer's taking the insured's risk away from the insured that creates insurance. It is the act of transferring risk from the insured to the market that makes a fixed index annuity insurance.

What risk does the insured pass to the insurer in a fixed index annuity? The risk that the insured would have kept in the absence of the contract, which is the non-beta risk. It is the transfer of this non-beta risk, that a fixed annuity insurer takes from the insured in exchange for premiums.

## 2. The Risk of Loss

In *American Equity*, the insurers argued that the insurers assume the risk of investing because if they invest badly they will have to pay the insured's payments with their own money, which is clearly true. But the

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<sup>109</sup> It must be acknowledged that the buyer does not receive full return of principal (either gross or net of fees).



court did not buy this argument because it believed that the buyer retained market risk over and above the guaranteed return.

What risk of loss does the fixed index annuity buyer bear? He bears a risk that the index will not perform well enough for him to receive a higher interest rate above the minimum.<sup>110</sup> But this is not a non-beta risk, because it does not depend upon stock picking; it is a market risk, it is beta. The insured bears the risk of not receiving a benefit, but this is not the same thing as a risk of loss. The insured bears the risk of short-term market downturns resulting in a loss of potential earnings. The *American Equity* court seemed to think that potential loss of potential earnings is a risk, but if you understand the theory behind index investing then it makes sense to suppose that the buyers themselves will not understand it as a risk, and the court should defer to their understanding.

Regarding the *American Equity* court saying that a fixed annuity with a five percent guaranteed interest rate is less risky than a fixed index annuity with a one percent guaranteed interest rate and a potential ten percent index-related interest rate, the court is comparing apples and oranges.<sup>111</sup> The comparison of apples to apples is a fixed annuity with a five percent interest rate compared to a fixed index annuity with a guaranteed five percent interest rate that could go up to ten percent based on an index.<sup>112</sup> That is the right example, but the court simply ignores it. In fact, a fixed index annuity is not riskier than a comparable fixed annuity.<sup>113</sup>

### 3. The Brennan Concurrence Argument

The Brennan concurrence in *VALIC*, as elaborated on in *United Benefit*, dictates that the insurance exemption does not apply where disclosure is the regulatory problem and does apply where contractual interpretation, solvency and reserves are the regulatory problems.<sup>114</sup> Disclosure and anti-fraud protections make a lot of sense with equity

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<sup>110</sup> He also has a certain loss of some fraction of his principal, maybe consisting of the insurer's costs, maybe more.

<sup>111</sup> See *supra* text accompanying note 98.

<sup>112</sup> All other things being equal, of course, including the guaranteed amount of principal returned.

<sup>113</sup> The court's argument regarding risk of loss is not totally invalid, but to the extent that there is a legitimate concern the states can adequately regulate fixed index annuities.

<sup>114</sup> See *supra* text accompanying notes 26-30.

investments, whose shares and financial information can be manipulated or misrepresented. Meanwhile, for the market risk aspects of fixed index annuities, the disclosure concerns are less. There are big problems with the calculation of the principal return on fixed index annuities and even with the calculation of the excess interest rate that require disclosure. But on top of that, fixed index annuities present insolvency concerns. State regulators can address both—the SEC cannot.

The gist of Brennan's *VALIC* concurrence is that the 1933 Act's purpose is to require disclosure so that investors can make an informed decision. Normally when purchasing an individual stock there is a very great deal of risk, and so it makes sense from a policy standpoint to ensure that the consumer is making an informed decision and knows what he is getting into. Otherwise there is the risk that the consumer may be taken advantage of, and even if he is not, he is still entitled to know and understand the details of where his money is going.

But this concern largely exists only for individual stocks and actively managed investment strategies, which present non-beta risk and can be amazingly complicated. Indexes are relatively simple compared to stocks, because the index is an aggregate that over the long-term reflects the strength of the market and the economy as a whole. The information necessary to disclose the risks of investing in an index are quite simple: the risk is only that the market and the economy will go up or down, and so disclosure of non-beta risk is a second order issue. In contrast, the terms of the fixed index annuity contracts, and concerns about the insurer making proper payments, having adequate reserves from which to make payments, and remaining solvent, are far more of an issue, and this falls generally under what Brennan claimed to be the scope of state insurance regulation. Therefore fixed index annuities should also be treated as insurance under Brennan's concurrence analysis.

The *American Equity* court seemed to have thought that the insurers were arguing that the insurance exception applies because state regulation is adequate and fixed index annuities contain no risk, which is a horribly oversimplified, incomplete account of what the insurers' argument was (or should have been) with respect to the Brennan concurrence.<sup>115</sup> What Brennan is saying is that the question is not whether adequate state regulation exists, but that there is a kind or genus of investment, called insurance, which presents different problems than the 1933 Act was designed to deal with, and therefore qualifying for the insurance exemption

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<sup>115</sup> See *supra* note 101 and accompanying text.

turns on whether the financial product contains the risks that insurance regulation was designed to prevent. Because the *American Equity* court mistakenly ignored the solvency risk inherent in fixed index annuities it thinks that the problem is the same as for stocks. Because the fixed index annuity is not based on picking stocks, disclosure is a lesser issue and the solvency and reserves regulation that Brennan claimed for the states is more relevant.

The needs for disclosure that the SEC claims are met by Rule 151A include disclosure of the terms of the contract, pricing, benefits, the details of the guarantees, and the ways in which the rate is calculated from the index.<sup>116</sup> None of the SEC's disclosure provisions pertain to the index itself, which is supposedly where the riskiness of the product comes from. Instead, they all have to do with the terms of the annuity contract, which are fundamentally no different than the contractual terms of a fixed annuity contract that are traditionally regulated by the states.

#### 4. The *United Benefit* Argument

The fundamental argument under the *United Benefit* rule, which can be seen as the updated version of *VALIC*, is that to be insurance the purpose of the financial product must be stability and security rather than growth through investment management.<sup>117</sup> The purpose of a fixed index annuity, like the purpose of index investing itself, is precisely this, to achieve stability and to enable money to grow at a greater rate without assuming any non-beta risk.

The MPT/CAPM theory shows that the purpose of index investing is stability and security, not growth. Can reasonable men differ on Modern Portfolio Theory? While people can differ on whether it is a good strategy for managing money, no one can dispute that its purpose is to reduce and spread risk, which is the definition of insurance. Similarly, no one can interpret index investing as investment management with the risks of stock-picking. The purpose of index investing is identical to that of a fixed annuity, to eliminate the risk of stock-picking. Its purpose is stability and security, not growth.<sup>118</sup>

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<sup>116</sup> Indexed Annuities And Certain Other Insurance Contracts, 74 Fed. Reg. 3138, 3161.

<sup>117</sup> See *supra* text accompanying notes 47-48.

<sup>118</sup> Indeed, the United States Supreme Court, when it adopted the "fraud on the market" theory for Rule 10b-5 securities fraud analysis, effectively endorsed the

The *American Equity* court repeatedly asserts that fixed index annuities appeal to consumers on the basis of growth rather than stability and security. Hence, according to the court, it necessarily follows that fixed index annuities are marketed like a security because their appeal is based on the performance of securities.<sup>119</sup> If that were true, people who buy fixed index annuities would buy variable annuities or individual stocks instead. What attracts people to fixed index annuities is not the assumption of investment risk in exchange for higher returns, it is a way to eliminate investment risk by investing in the market over the long term by means of products whose guarantees of interest and principal eliminate the risk of loss in the event that the index has a short-term loss. The *Malone* court found as much.<sup>120</sup> Therefore, if marketing is a necessary prong in the analysis the SEC was unreasonable because the product, ever so far from appealing as an investment risk, has as its main appeal, and has achieved widespread popularity, as a means of using index investing to reduce and eliminate investment risk.

## B. POLICY CONSIDERATIONS

### 1. What Should SEC Worry About?

With the recent troubles on Wall Street the SEC has enough to worry about in preventing frauds involving traditional stocks without expanding its mandate to claim regulatory control over every financial product that it can get its hands on. The SEC would perform best if it kept to a tightly focused mission and did not overextend itself by becoming too broad. Such a strategy would utilize the SEC's limited resources in the most efficient manner.

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efficient market hypothesis which underlies much of Modern Portfolio Theory and Capital Asset Pricing Model. *See* *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

<sup>119</sup> *See supra* text accompanying notes 94-96, 100

<sup>120</sup> *See supra* text accompanying note 86.

## 2. Consumer Protection

Some commentators have argued that SEC regulation is necessary to protect insureds from fraud by fixed index annuity insurers.<sup>121</sup> However, the kind of fraud of which there is a risk is not distinctly securities fraud and is such that state insurance regulators can guard against it.

## 3. Cost-Benefit Analysis

As SEC acknowledged, compliance with Rule 151A could cost the insurance companies many millions of dollars, even up to \$800 million.<sup>122</sup> There seems to be little benefit to the consumers who would eventually be forced to bear these costs. In the contemporary recession-plagued economy there is no basis for placing a major burden on the insurance industry absent a compelling justification, especially when it is the fixed index annuity consumers who will ultimately pay the SEC's bills.

## 4. The Benefits of State Regulation

There are classic yet relevant arguments that states are just as competent as the Federal government, that allowing freedom to the states increases experimentation which leads to progress and innovation in regulation, and that the Federal government is bureaucratic and inefficient.<sup>123</sup> These ideas remain forceful today.<sup>124</sup>

## VI. CONCLUSION

The variable annuities in *VALIC* and *United Benefit* were investment management products masquerading as insurance in order to

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<sup>121</sup> E.g., J.S. Coleman, *Equity Indexed Annuities: "Securities," or Exempt Insurance Products Under the Federal Securities Laws?*, 34 no. 2 SEC. REG. L.J. Art. 1 (2006).

<sup>122</sup> See *Indexed Annuities And Certain Other Insurance Contracts*, 74 Fed. Reg. at 3168.

<sup>123</sup> E.g., Douglas R. Richmond, *When It Comes to Insurance Regulation, Is Uncle Sam the New Sheriff in Town?*, 2008 EMERGING ISSUES 2696; see *supra* text accompanying notes 37-39.

<sup>124</sup> Indeed, it is worth noting that during the housing boom which led to the recent recession, insurance regulation largely worked better than federal securities regulation.

escape from the SEC, but that doesn't mean that it is impossible for a securities-related financial product to truly be insurance. Fixed index annuities are such a product. From a policy viewpoint, too much unnecessary regulation is unwise and inefficient. From a legal viewpoint, a logical argument can be made that an insightful analysis of the case law on the insurance exemption in the Securities Act of 1933 combined with an astute understanding of the facts involving fixed index annuities leads to the conclusion that fixed index annuities qualify for the insurance exemption. Even if the United States Supreme Court is unwilling to overturn *American Equity*, hopefully this note will provide a conceptual framework involving risk-reward analysis for future judges to use going forward so that the insurance exemption in the 1933 Securities Act continues to function. There is every reason to believe that imaginative, creative financial entrepreneurs will develop new kinds of insurance, some of which may be connected to securities, and even though the trend seems to be towards giving the SEC control over all new securities-related financial products, it would be unfortunate to see a day when insurance exemption analysis is abandoned and every securities-related insurance product is automatically classified as a security.

